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RESEARCH REPORT

The impact of the economic crisis on the International banking system and on the marketing and management strategies, and the path of Romania towards the adoption of the Euro currency

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Introduction

The idea of my chosen PhD dissertation topic in 2007: „Marketing and Management strategies in the International and Romanian banking systems" was to take a deep look into the Romanian banking sector and compare the marketing and management strategies to those used on an international scale. After that, the intent was to see which strategies can be applied in Romania, taking into consideration the economical, political and cultural background of our country.

In 2008, the international financial crisis has spread around the globe and has hit most the banking sector. This sector has had therefore reconsidered its practices and has started to change. Therefore, what once were modern and widely accepted marketing and management strategies, now have been put under revision.

Besides this, the crisis has spread from the banking sector to all areas of the economy in most countries around the world in different ways. Some countries took a strong blow: Iceland, while others managed to dodge it: Poland. One thing is certain: without proper economic strategies and reforms, many countries face the risk of going bankrupt.

In the United States, the Obama Administration has adopted major measures to avoid the crash of the financial sector through gigantic bailouts amounting to hundreds of billions of dollars. In Europe, Asia and other countries of the world, similar measures have been taken, certainly at a lower level, but in proportion to the size of the respective economies. Of these countries, many have requested the help of renowned international financial institutions: the IMF, the World Bank, EBRD and European Commission.

Besides the purely economic aspects of the crisis, other issues have become of primary importance: business ethics, accountability, proper control mechanisms to prevent abuse, market regulation, to name a few. I will do my best to address these issues in the present work.

Taking into consideration all these elements, my work has become much more interesting since the initial intent was to compare what Romania has to do to align itself to the best international banking practices. As mentioned before, this intent has become even more interesting because of the financial crisis of 2008 which has triggered a worldwide review of the financial, banking, and economic models.

As a final note before moving on to review the issues mentioned in the previous paragraphs, I must point out that the two chapters of this work will in some form, become part of the final PhD dissertation to be presented in 2010. One more thing that must be mentioned is that I have chosen to write the original version of this work in English because the materials used in the bibliography are mostly in English, and I wanted to maintain the form of the original expressions, given the fact that the results of the present work will be published abroad. Keeping this in mind, I would like to thank the members of the commission of the Academy of Business Studies of Bucharest for their understanding, and I would like to assure them that I will do my best to make available as soon as possible a translation in Romanian.
One last note: the graphs and charts in this paper are from The Economist publication, unless otherwise mentioned.

1. Chapter I – The impact of the financial crisis on the world economies and on the banking sector

1.1. An overview of crashes and crises

1.1.1. The great crash of 1929

After the Great Depression that occurred between 1929 and 1933, many economists have asked themselves if it could happen again. It is clear that many lessons were learned since then, and many books have been written on this subject, however times change, and so does the world economy.

To better understand what the Great Depression meant, Mr. Liaquat, in the book "Lords of Finance" gives us precious insight: *"During a three-year period, real GDP in the major economies fell by over 25 percent, a quarter of the adult male population was thrown out of work, commodity prices fell in half, consumer prices declined by 30 percent, wages were cut by a third. Bank credit in the United States shrank by 40 percent and in many countries the whole banking system collapsed. Almost every major sovereign debtor among developing countries and in Central and Eastern Europe defaulted, including Germany, the third largest economy in the world. The economic turmoil created hardships in every corner of the globe, from the prairies of Canada to the teeming cities of Asia, from the industrial heartland of America to the smallest village in India. No other period of peace time economic turmoil since has even come close to approaching the depth and breadth of that cataclysm."*[1]

Part of the reason for the extent of the world economic collapse of 1929 to 1933 was that it was not just one crisis but, as I describe, a sequence of crises, ricocheting from one side of the Atlantic to the other, each one feeding off the ones before, starting with the contraction in the German economy that began in 1928, the Great Crash on Wall Street in 1929, the serial bank panics that affected the United States from the end of 1930, and the unraveling of European finances in the summer of 1931. Each of these episodes has an analogue to a contemporary crisis.
The first shock—the sudden halt in the flow of American capital to Europe in 1928 which tipped Germany into recession—has its counterpart in the Mexican peso crisis of 1994. During the early 1990s, Mexico, much like Germany in the 1920's, allowed itself to borrow too much short-term money. When U.S. interest rates rose sharply in 1994, Mexico, like Germany in 1929, found it progressively harder to roll over its loans and was confronted with a similar choice between deflation or default.
There are, of course, differences. Germany in 1928 was much larger compared to the world economy—about three times the relative economic size of Mexico in 1994. But the biggest difference was to be found in the management of the crisis. The U.S. Treasury under Secretary Robert Rubin forestalled a default by providing Mexico an emergency credit of $50 billion with astonishing rapidity. Germany in 1929 had no such savior. Moreover, in*

[1] Ahamed, Liaquat: "Lords of Finance – 1929, The great depression, and the bankers who broke the world", William Heinemann 2009, London, p. 497

1994, Mexico could devalue the peso. In 1929, having only just emerged from a terrible bout of hyperinflation, Germany felt bound by gold-standard rules and sacrificed its economy to maintain the parity of the Reichsmark.
The second crisis of the series, the Great Crash, has a very obvious modern-day parallel in the fall of the stock market in 2000. Both followed a frenzied bubble in which stocks completely lost touch with economic reality, becoming grossly overvalued—by most measures 30 to 40 percent. In both cases, after the sell-off it became apparent that much of the rise had been pushed by a rogue's gallery of Wall Streeters and corporate insiders.

1.1.1.1. What triggered the crisis?

According to Mr. Liaquat, *"More than anything else, therefore, the Great Depression was caused by a failure of intellectual will, a lack of understanding about how the economy operated. No one struggled harder in the lead-up to the Great Depression and during it to make sense of the forces at work than Maynard Keynes. He believed that if only we could eliminate "muddled" thinking—one of his favorite expressions—in economic matters, then society could allow the management of its material welfare to take a backseat to what he thought were the central questions of existence, to the "problems of life and of human relations, of creation, behavior and religion." That is what he meant when in a speech toward the end of his life he declared that economists are the "trustees, not of civilization, but of the possibility of civilization." There is no greater testament of his legacy to that trusteeship than that in the sixty-odd years since he spoke those words, armed with his insights, the world has avoided an economic catastrophe such as overtook it in the years from 1929—33."*[2]
It seems that the world has learned its lesson and avoided up to now another Great Depression, but the causes behind the new financial crisis are different, and the world shouldn't shun away from preventing an even larger financial and economic disaster.

1.1.2. Other modern day crises

The "emerging markets" crisis of 1997-98 is the modern-day counterpart of the 1931 financial crisis when *"the evaporation of confidence in European banks and currencies caused Germany and much of the rest of Central Europe to impose capital controls and default on their debts, leading to a contagion of fear that culminated in forcing Britain off the gold standard."*[3]

"In 1997, a similar sequence of rolling crises afflicted Asia. South Korea, Thailand, and Indonesia all had to suspend payments on hundreds of billions of dollars of debt. Asian currencies collapsed against the dollar, undermining all confidence in emerging-market securities and eventually setting off the default of Russia in 1998 and of Argentina two years later. But in 1931, that part of Europe affected by the crisis was about half the size of the U.S. economy; in 1997, the GDP of the emerging markets that defaulted represented about a quarter of U.S. GDP."[4]

"As with all analogies, the comparisons are never exact. Nevertheless, they illustrate the scale of the economic whirlwind of 1929-32—a crisis equivalent in scope to the combined effects and more of the 1994 Mexican peso crises, the 1997-98 Asian and Russian crises, the

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[2] Ibid, p. 504
[3] Ibid, p. 504
[4] Ibid, p. 504

2000 collapse in the stock market bubble, and the 2007/8 world financial crisis, all cascading upon one and other in a single concentrated two-year period. The world has been saved in part from anything approaching the Great Depression because the crises that have buffeted the world economy over the past decade have conveniently struck one by one, with decent intervals in between."[5]

The symptoms of the crises that followed the Great Depression, can be considered in part similar, however, they are never really identical. The mechanisms that represent the foundation of all economic and financial activities are in great part the same. Therefore it is normal that different crises manifest in one way or another in a similar manner. The fact is that most characteristics don't change: there is a drop in confidence in financial markets, in the economy as a whole, many financial institutions and firms default on payments, local currencies devaluate (especially those of developing countries), unemployment soars, financing is harder and more expensive to get, assets depreciate and there is social unrest.

1.1.3. The Crash of 2008

According to Paul Krugman an economist and New York Times columnist and Hank Paulson, a former American treasury secretary[6] a combination of two factors is at the root of the financial crisis of 2008:

- the huge current-account surpluses run by countries like China,
- the huge deficit of the US"[7]

On the other hand, the International Monetary Fund has a different opinion. The IMF considers that the two main factors behind the crisis are:

- deficient regulation of the financial system
- the failure of market discipline [8]

We can better understand the policies of the IMF from the point of view of its chief economist, Olivier Blanchard, that said that global imbalances contributed only "indirectly" to the crisis. This view shouldn't be seen as passing the responsibility to others, instead it is important in figuring out if macroeconomic policy or more regulation of financial markets will provide the solutions to solving this issue.

The Economist states that: *"The global imbalances view asserts that large quantities of money from countries with high savings rates, such as China and oil-producing states, came to the US. This has determined that interest rates be kept low, fueling the credit boom that in turn generated an increase in the price of assets, that ultimately collapsed generating the financial crisis. The solution to this problem would be to find a way to deal with these imbalances."* [9]

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[5] Ahamed, Liaquat: "Lords of Finance – 1929, The great depression, and the bankers who broke the world", William Heinemann 2009, London, p. 501
[6] Finance & Economics – World economy: „What went wrong", From Economist.com, Mar 6th 2009
[7] Ibid
[8] Ibid
[9] Economics focus: "The global slumpometer", From The Economist print edition, Nov 6th 2008

The IMF on the other hand argues that the imbalances alone couldn't have caused the crisis without the *"creative ability of financial institutions to develop new structures and instruments to cater to investors' demand for higher yields."*[10] In fact, *"these instruments turned out to be more risky than they appeared."* The investors, preferred to rely on the analysis of credit-rating agencies which were, in some cases, also selling advice, and were too optimistic about continued rises in asset prices, and did not look closely into the nature of the assets that they bought. The IMF argues that this "failure of market discipline", played an important role in the crisis.

The IMF also states that financial regulation was flawed, ineffective and too limited in scope. The fund believes that the investment banks, hedge funds, mortgage originators, and the like represented a highly interconnected network that was not subject to the prudential regulation that applies to the banks. They call it the "shadow banking system".

This parallel banking system became affiliate to banks that pushed the risk into these entities believing that they were not systemically important. However, these entities grew very large indeed, becoming "too big to fail". The value of this shadow banking system reached $10 trillion in 2007, the same value as the regulated banking system of the US.

The IMF is trying through these measures to force regulation on the shadow banking system in order to concentrate on the actual activities that these entities conduct. Basically, they want to concentrate on leverage, funding and interconnectedness that contribute to systemic risk. In order to achieve this, more regulation would have to be adopted to cover cross-border banking, disclosure requirements, indices of systemic risk and international co-operation.

The issue discussed here is how to prevent in the future, similar phenomena, but in order to achieve such ambitious task, we have to look at what favored the growth in size of financial institutions that have gamed the regulatory system. The IMF may be in part responsible for determining Asian countries to build up gigantic reserves during the Asian crisis. Some argue that now that the IMF is trying the impossible: to anticipate all the possible ways in which regulations can be evaded. However, the creativity of financiers goes beyond the scope of the IMF. The Economist believes that the IMF is putting too much burden of the cause of the crisis on the risky financial instruments that have increased systemic risk, which would not have been possible without the vast amounts of money thirsty for returns, that have flooded the US.[11]

1.2. The Financial Crisis in the US

The Economist states that the recession started in 2008 could be considered the worst recession since the Great Depression of the 1930s, for rich countries, while for poorer countries, the recession could be relatively mild.[12] It is considered the worst global recession since the 1930s. Labeling it this way has an impact on the behavior of economic activity worldwide: it discourages spending by households and businesses, depressing output even more.

[10] Ibid
[11] Ibid
[12] Ibid

According to the widely accepted rule, that two successive quarters of falling GDP means there is a recession. It's true that America, Great Britain, the euro area countries, and Japan, are in recession according to this rule. However, it takes more to call it a worldwide recession.

The International Monetary Fund, in its World Economic Outlook, published on November 6th, *"predicted that world GDP growth would fall to 2.2% in 2009, based on purchasing-power parity (PPP) weights, from 5% in 2007 and 3.7% in 2008."*[13]

According to the past assertion of the IMF that global growth of less than 3% implied a world recession, this would mean that the whole world is in recession. One could ask himself if according to this view, growth of 2.9% should be viewed as a recession. I believe that the unit of measure cannot therefore be the same for developed and developing countries. The main issue here is that there is no agreed definition of a global recession. If we use the two successive quarters of falling GDP method for developing countries, this doesn't mean that it can be used when analyzing the world as a whole, because many emerging economies do not report seasonally adjusted quarterly GDP figures.[14]

In the same manner, downturns are seldom perfectly synchronized across countries, so *"even if most countries contract at some stage during a two-year period, global GDP growth may not turn negative."*[15] As a matter of fact, since the 1930s Depression, the global GDP has never fallen in any year. The worst 2 results on record so far, were registered in the year 1982 with growth of 0.9% and in 1991 with growth of 1.5%.

The methods used for calculating world growth have to keep in mind the increase in population, since a commonly used method, GDP per head is influenced by variations in world population. Another way to calculate growth is PPP - purchasing power parity. "If market exchange rates are used to measure world output instead of PPPs*, then some recent forecasts would imply a fall in world GDP per head. However, the IMF believes that PPP weights are more appropriate, because a dollar buys a lot more in poor countries than in America, thanks to lower prices. Converting China's GDP into dollars at market exchange rates therefore understates the true size of its faster-growing economy and, in turn, understates world growth."[17]

The IMF's definition of global recession also takes account of the fact that the trend growth rate in emerging economies is higher than in developed ones, so even a steep downturn will leave GDP still expanding. A growth rate of 4% would count as a boom in America, but a recession in China. Nevertheless, some economists reckon that the IMF's 3% benchmark for global recession may be too high. UBS, for instance, suggests a demarcation point of 2.5%. Even the IMF now seems less sure. At the original launch of the *World Economic Outlook* in October, Olivier Blanchard, the fund's chief economist, said "it is not useful to use the word 'recession' when the world is growing at 3%".

When tracking such diverse economies, it does make much more sense to define a global recession not as an absolute fall in GDP, but as when growth falls significantly below its

[13] Ibid
[14] Ibid
[15] Ibid
[16] Ibid

potential rate. This can cause anomalies, however. Using the IMF's definition (ie, growth below 3%), the world economy has been in recession for no fewer than 11 out of the past 28 years. This sits oddly with the fact that America, the world's biggest economy, has been in recession for only 38 months during that time, according to the National Bureau of Economic Research (the country's official arbiter of recessions), which defines a recession as a decline in economic activity. It is confusing to have different definitions of recession in rich and poor economies.

Before proclaiming global recession, it is also important to consider the extent to which a downturn has spread around the world. As stockmarkets and currencies have slumped in emerging economies and some governments have had to knock on the IMF's door, it might appear as if these economies are being hit harder than rich countries. Even in China, growth seems to be slowing sharply, prompting the government to lift its quotas on bank lending at the start of this month. Yet most emerging economies are still widely expected to hold up much better than in previous global downturns.[18]

According to The Economist, while developed countries of the world will suffer a major decline in 2009, the emerging economies will account for more than 100% of world growth.[19]

1.2.1.1.1. Where it all began

The Economist believes that the global financial crisis started in American residential property, thanks to ludicrously lax subprime lending, but it spread to other asset classes. The Federal Reserve extended in August 2009, the life of a facility to support asset-backed securities, but it was more out of concern for commercial property than for housing.[20]

Observers agree that America's economy - and all those banks still saddled with underperforming mortgages - will struggle to recover while house prices are still falling.

Rising joblessness will continue to weigh on demand for homes. The unemployment rate, currently 9.4%, is expected to peak at more than 10% some time next year. The economic effect of unemployment is wider: as more and more of those still in work know someone who has lost their job, they will think twice before buying a property. Consumer confidence remains fragile.

For those seeking a mortgage, credit is still hard to come by. The two main federally backed mortgage agencies, Fannie Mae and Freddie Mac, have tightened their standards for new loans (though mortgages handled by their sibling, Ginnie Mae, have fallen in quality). A Federal Reserve survey of loan officers, released on August 17th, suggested that banks will remain tight-fisted for some time. They are still grappling with growing losses from residential mortgages. These will not peak until early next year, reckons Betsy Graseck of Morgan Stanley.

Moreover, the positive signs in housing are partly driven by short-term factors. One is the tax credit for first-time buyers that was included in Mr Obama's stimulus package: some are

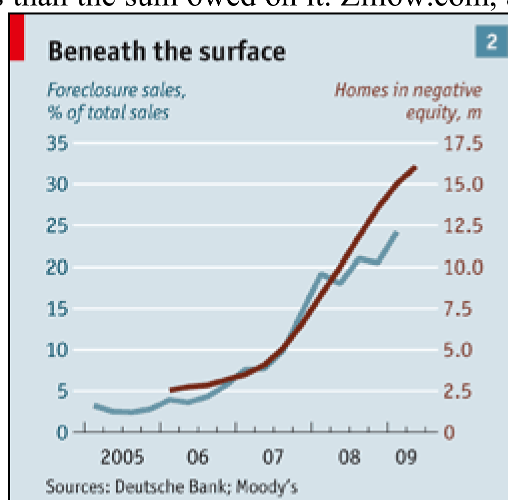
[18] Ibid
[19] Ibid
[20] Finance & Economics - America's housing market: „Where it all began", From The Economist print edition, Aug 20th 2009 | NEW YORK

rushing to buy now because deals must close by November 30th to qualify. Annual tax refunds, handed out in recent months, may also have given the market a temporary lift.

Foreclosures are running at record levels, with one in 355 of the nation's homes receiving a filing in July alone. Seized properties now account for almost one in four sales (see chart 2). Increasingly, those losing their homes are supposedly safer borrowers with "prime" mortgages. They now account for more foreclosures than subprime borrowers, says the Mortgage Bankers Association (MBA). [21]

With 1.8m homes already in foreclosure, a "similar amount" may be heading that way, reckons Torsten Slok, an economist at Deutsche Bank.

The rise in negative equity - when a borrower's mortgage debt exceeds the value of his home - is also fuelling foreclosures, not least because many would rather walk away than keep making payments on a home that is worth much less than the sum owed on it. Zillow.com, a property-information service, estimates that 23% of homes with mortgages are underwater. Others put it higher. A staggering 60% are submerged in Las Vegas. Deutsche Bank's securitization team expects negative equity to peak at 48% of total homes by 2011. That may be too pessimistic, but all agree that the number will rise further. This matters because negative equity weighs doubly heavily on home prices, by both weakening demand (it traps potential buyers in their homes) and adding to supply (it often ends in seizure and distressed sales).



Government efforts have done little to stop the rot. Under the main foreclosure-prevention programme, only 235,000 struggling borrowers have had their loans altered to make payments more affordable, out of 4m targeted for help. Even with a financial incentive to modify, loan servicers remain reluctant. Many borrowers are too deep in negative equity and the redefault rate is too high. "It doesn't help if you're drowning in 20 feet of water instead of 30," says Jay Brinkmann, the MBA's chief economist. Moreover, the typical troubled mortgage is getting harder to modify because it is more likely to be the result of unemployment than an interest-rate increase. Bringing the monthly payment down by 20% does not help when the borrower has no job.

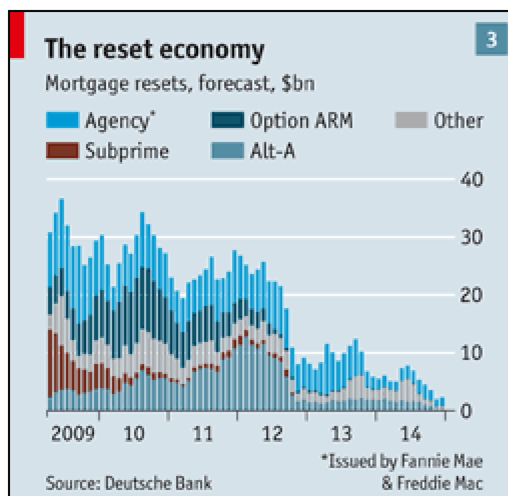
This is also true in Romania, where banks have started to reduce the monthly payments on mortgages while extending the credit period. However, many people have lost their jobs, both in the public and in the private sector. Banks however find it hard to do foreclose the homes of defaulting clients because the real estate market has dropped in value and the lack of financing prevents many potential customers from buying.

Many homeowners (in the US), who sat tight while prices fell will try to sell at the first sign of a turnaround, according to surveys prime and subprime and a nasty type of mortgage called an "option ARM" (see chart 3). The impact may be muted, but only if the Fed can keep short-term rates very low for the next couple of years—or if the borrowers can

[21] Finance & Economics - America's housing market: „Where it all began", From The Economist print edition, Aug 20th 2009 | NEW YORK

refinance as the reset approaches. These types of people can be seen as risk adverse, they buy at a high price and sell at a low price. At the slightest sign of price increase, they will sell.

Most economists expect the price of houses to fall by a further 5-10 percentage points, to their long-term trend line at roughly 40% below their peak, and not to reach bottom until some time in 2010. The pessimists predict they will go crashing through the trend-line to as little as half their 2006 high.



Analysts at Goldman Sachs, no fools when it comes to housing, hint at several years of stagnation. They argue that the rate of home ownership, currently just over 67%, will fall back to the 64-65.5% level that prevailed before prices took off in the mid-1990s, cutting deeply into demand for properties. This view is supported by a recent Fed study, which found that more than half of the boom-era rise in ownership was due to "innovative" mortgage products, many of which are now history.[22]

Considering all aspects of the housing market in the US, we have to keep in mind that these "economic phenomena" generated by the crisis, foreclosures, soaring unemployment, the drop in consumption, the drop in asset prices and many more of the kind determine social distress. Many people will be left without homes, to fend for themselves. Once respectable US citizens will have nothing, no house, no jobs, no future. This is not just an economic issue to analyzed mathematically. Someone has to be responsible for solving all these problems, and who else than those that allowed cheap credit to be given to anyone asking for it?

1.2.2. The Federal Reserve and its chairmen

The mission of the Federal Reserve is supposed to be one mainly concerned with stability and prudence. From the Fed's website we learn that its three responsibilities towards the public are as follows:

1. Conducting the nation's monetary policy by influencing money and credit conditions in the economy in pursuit of full employment and stable prices;
2. Supervising and regulating banking institutions to ensure the safety and soundness of the nation's banking and financial system and to protect the credit rights of consumers;
3. Maintaining the stability of the financial system and containing systemic risk that may arise in financial markets.[23]

1.2.2.1. Alan Greenspan

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[22] Finance & Economics - America's housing market: „Where it all began", From The Economist print edition, Aug 20th 2009 | NEW YORK

[23] Fleckenstein, William A.: "Greenspan's Bubbles", McGraw Hill 2008, USA, pp 1-3

The Chairman of the Federal Reserve from 1987 to 2006 was Alan Greenspan. This period is referred by some as the Greenspan Era.
It is argued if the legacy Alan Greenspan has left behind is a positive or negative:

"A debate has emerged in this country regarding the legacy Alan Greenspan has left after his nearly 19 years as Chairman of the Federal Reserve. Some have argued that Greenspan ushered in an era of prosperity. Others would counter that his decisions have nearly led to the decimation of the world's largest financial system. Who is correct?
If Wall Street had a chisel, Alan Greenspan's smiling face would today be carved on Mount Rushmore. From the late 1980s until just recently, the Maestro, as an admiring journalist styled him, could seemingly do no wrong. He set interest rates[1] —always, so his fans insisted —the right rates. He presided over an economy that only rarely stumbled into recession or crisis. And when it did lose its way, the Greenspan Fed could be counted on to ease the pain with freshly printed dollars and low interest rates.
The archetypical central banker is dour and fretful, but Greenspan broke the mold. Polite, self-effacing, and pleasant, he gave no offense, even when badgered by his critics in the endless congressional hearings to which every Fed Chairman is subjected. He could scold and worry—usually on matters over which the Fed had no control—but his characteristic posture was one of sunny optimism. The computer revolution, financial innovation, and the globalization of trade and investment were, for him, developments of immense promise. Don't worry, he assured the United States. Wall Street heartily agreed. The future glowed bright. Newly printed dollars and low interest rates were a fabulous stimulant for investment assets and real estate.
But consider how your own life has changed over the last few years. How have Greenspan's actions affected your stock portfolio, 401(k), or mortgage? Will you be better off for having lived through the Greenspan era, or will you be much poorer for having done so?
The truth is that the majority of Greenspan's decisions as Fed Chairman from August 11, 1987, to January 31, 2006, were not beneficial to you, nor did they leave the country better off, despite Greenspan's glowing self-critique in his own book, The Age of Turbulence. In reality, the overwhelming majority of people in the United States will find that they are worse off in the years ahead as a result of his stewardship.
Some might ask, "He's the Fed Chairman; how could he have been wrong?" My response is: Greenspan erred by continually picking an interest rate that was too low, then he solved the turmoil that resulted from that decision with another period of interest rates that were again too low. The result was that, during his reign, the United States experienced a bubble in stocks and then in real estate.[2] These two massive bubbles emerged within 10 years of each other. Prior to Greenspan's arrival at the Fed, excluding the brief mania for commodities and precious metals from late 1979 to early 1980, the country had been bubble-free for over 50 years."[24]

In the view of the author William Fleckenstein, the legacy left behind by Alan Greenspan "will be a treacherous one to navigate that will leave many wounded in its wake." He also believes that "there is no debate: Greenspan was no "Maestro"; he was the master of the United States' descend into financial turmoil. The evidence speaks for itself".[25]

According to Alan Greenspan, *"Inflation overall may be contained for a while by weakness in the world economy, induced by the credit crunch. But the respite, if it can be called that, won't last. Inflation is returning, if anything more quickly than projected in these pages a*

[24] Ibid, pp 3-5
[25] Ibid, p 187

year ago. As the gradual unwinding of post cold war disinflation makes way for pervasive inflationary forces, keeping these from getting out of hand will become the primary challenge for the world's central banks. If we are lucky, the central banks will get the same steadfast political cover that President Ronald Reagan gave the Federal Reserve when runaway inflation last threatened the U.S. economy. Central banks need such support to counter with uncomfortably high interest rates the deteriorating inflation outlook.
Thus I continue to expect to see higher long term U.S. interest rates in the decade ahead—treasury bonds that at times will flirt with double-digit yields and stocks, real estate, and other income-earning assets that perform in a more subdued fashion in the next two decades than they did in the past two decades. It is to this challenge that economic policy must now turn. Economic bubbles, the phenomena that have so shaped and shaken our lives in recent years, will for the foreseeable future be of less concern. The reason is simple: Bubbles form in periods of ample credit and low long term interest rates - circumstances the world is unlikely to encounter again for years."[26]

1.2.2.2. Ben Bernanke (reconfirmed by Obama for a new 4 year term)

Ben Bernanke is the successor of Alan Greenspan as the Chairman of the Federal Reserve. President Obama took office in 2008 and has kept him in his current position of Chairman of the Fed, and now, in 2009, he has reconfirmed him for a new 4 year term.

"The decision was widely hailed on Wall Street and in Washington, DC. With few exceptions, politicians and economists lined up to praise Mr. Bernanke and to laud Mr. Obama for keeping him." [27]

The decision was a good one, for two important reasons:

- The first, is that Mr Bernanke has done a good job of dealing with the worst financial crisis since the 1930s. However, we should keep in mind that Mr. Bernanke was complicit in creating the loose monetary conditions which fuelled the financial frenzy in the first place.[28]

Mr. Bernanke is now responsible for fixing problems that he in part helped to create. *"As a governor of the Fed earlier this decade, he was even more convinced than Alan Greenspan that central banks had no business raising interest rates to head off asset bubbles."*[29]

The leaders of several other rich-world central banks have also acted boldly.

Nonetheless, Mr. Bernanke's academic research gave him an acute appreciation of the risks posed by dysfunctional financial markets. His willingness to experiment with unconventional monetary-policy devices allowed the Fed to counter financial collapse even as America's politicians were paralyzed. And his mild, diplomatic manner brought much-needed calm amid the crisis.

The second reason why the renomination makes sense has less to do with Mr Bernanke's strengths than with the dangers of ditching him. The likely alternatives were not obviously

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[26] Greenspan, Alan: "The age of turbulence", Penguin Books 2008, London, pp 531-532
[27] Leaders - The Federal Reserve: „Right man, rough job", From The Economist print edition, Aug 27th 2009
[28] Ibid
[29] Ibid

superior to the incumbent. Given the broad consensus that he has handled the crisis well, replacing him, especially with an obvious Democrat, would have whiffed of politicization. True or not, that perception would have damaged the Fed and thus the economy. America's central bank is already in its most parlous political position in generations, under fire from the left for failing to prevent financiers' excesses and from the right for swelling its balance-sheet and overstepping its remit. It is caught up in a furious debate over financial regulation, and has little popular support. According to one poll, of all the government agencies, the Fed has the lowest popularity rating. (as seen in the chart).

Mr. Bernanke's reappointment has defused that danger. But far more perilous times lie ahead. For both substantively and politically, the tasks over the next four years may be harder than handling the crisis itself. There will be no quick return to business as usual for the Fed or any other central bank. The Fed's monetary stance must be loose enough for long enough to prevent the economy sinking into a deflationary quagmire, but must be tightened quickly enough to stop inflation soaring. While the short-term rates are close to zero, the monetary balancing-act will have to be achieved on untested ground.

From a political point of view the difficulties will be greater. Mr. Bernanke will have to push through regulatory reform so that the Fed is not left with too many responsibilities and too little tools with which to carry them out. He must backup the logic behind its monetary decisions but at the same time resist attempts to influence them.

Mr. Bernanke has earned his reappointment by showing that he is a bold and creative crisis-manager. In his second term he will need just as much technical competence as he has shown in his first, and even more political backbone.[30]

When appointing Mr. Bernake for a new 4 year term at the leadership of the Fed, Mr. Obama stated: *"As an expert on the causes of the Great Depression, I'm sure Ben never imagined that he would be part of a team responsible for preventing another,"* and continued *"But because of his background, his temperament, his courage, and his creativity, that's exactly what he has helped to achieve."*[31]

Mr. Bernanke's capitalized on his academic background when he pleaded with politicians to bail out the system. *"I'm a college professor,"* he told Congress as it debated the $700 billion Troubled Asset Relief Programme. *"I never worked on Wall Street… My interest is solely for the strength and the recovery of the US economy."*

Difficult as Mr. Bernanke's first term was, his next will be more politically treacherous. The recovery now under way will be feeble: deflation will remain a bigger threat than inflation for at least a year. Yet early signs of growth will generate pressure to tighten monetary policy which Mr. Bernanke must beat back without seeming soft on inflation.

[30] Ibid
[31] Finance & Economics: "Ben Bernanke's reappointment", From The Economist print edition, Aug 27th 2009 | WASHINGTON, DC

Once the recovery is entrenched and unemployment is falling, he will have to raise interest rates and shrink the Fed's balance-sheet, inviting attack from Congress and perhaps Mr Obama. He will also have to create a new monetary regime to replace the single-minded focus on low inflation, says David Blanchflower, who recently quit the Bank of England's monetary policy committee. The Fed may have to intervene in markets more to prevent new bubbles. But that, like tightening monetary policy, is unpopular and the Fed is already in bad odour with the public (see chart).

Still, Mr. Bernanke is probably up to these challenges. Mr. Obama has strengthened him immensely, by nominating the 55-year-old Republican long before his term expires rather than leaving him dangling or replacing him with a Democrat. More important, Mr. Bernanke has shown he can adapt academic theory to the political reality in which the Fed operates.

Mr. Bernanke was appointed to the Fed in 2006 mostly on his academic credentials. As a professor at Princeton University, then a Fed governor under Mr. Greenspan and briefly an adviser to George Bush, he helped build the edifice of macroeconomic orthodoxy that has proven so badly flawed. He argued that central banks performed best by concentrating solely on inflation, preferably with a target. To an even greater degree than Mr. Greenspan, he was sure that using monetary policy to try to stop asset-price bubbles would do more harm than good.[32] Mr. Bernanke believed in the macroeconomic assumption that markets were, most of the time, rational and efficient and in September 2005, he declared: *"Recent house price increases are attributable mainly to economic fundamentals." Jeremy Grantham, a fund manager, has said Mr. Bernanke's faith in efficient markets was so strong that he could not see a once-in-a-century bubble in home prices because such a bubble wasn't supposed to be possible.*

Even if *Mr. Greenspan takes the blame for planting the seeds of the crisis by holding interest rates low after the 2001 recession it was Mr. Bernanke* that backed up this strategy from an academic standpoint. *As late as August 7th 2007, days before the crisis erupted, the Fed said it was more worried about inflation than about a weakening economy.*

But once the gravity of the crisis became clear, Mr. Bernanke knew what he had to do. Financial institutions, unsure who was fatally exposed to toxic securities, began to hoard liquidity (cash and super-safe government debt) and withhold credit from each other. As liquidity dried up, some institutions failed and others reduced their lending to businesses and households, starving the broader economy. When everyone wants liquidity, only the central bank can supply more. Over the next 20 months, Mr. Bernanke employed ever more creative means to inject liquidity into the financial markets. He also used conventional monetary policy, eventually cutting short-term interest rates close to zero and attempting to lower long-term interest rates by purchasing bonds. But the Fed needed a functioning financial system to transmit the benefits of such actions to the broader economy.

He was not the only central banker to come to this realization, or even the first. When the crisis first broke in August 2007, the European Central Bank (ECB) was more aggressive in its initial response, providing at first unlimited cash to euro-zone banks. Similarly, the Fed's decision to throw its weight behind Bear Stearns, American International Group and Citigroup, had its analogues abroad: the Bank of England provided a lifeline for Northern

[32] Finance & Economics: "Ben Bernanke's reappointment", From The Economist print edition, Aug 27th 2009 | WASHINGTON, DC

Rock and the Swiss National Bank later backstopped UBS. All central bankers, not just those who are authorities on the Depression, know that in a crisis, the failure of a single financial firm can trigger contagion and the collapse of its counterparties, endangering the entire financial system and economy.

Europe's economy remains bank-dominated. America's once was, too, and the Fed's tools reflect that: it can ordinarily lend only to banks from its discount window. But America's economy is now dominated by a shadow banking system of investment banks, financial firms and investment funds.

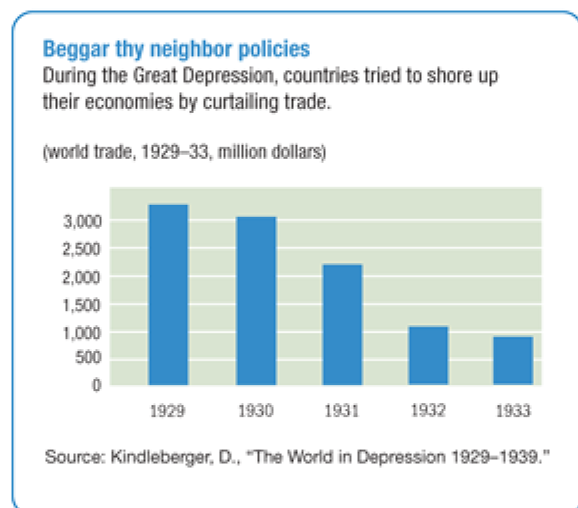
Professional economists have applauded Mr. Bernanke's actions, but the public has not. The Fed's approval rating stands at just 30%, lower than any other federal agency and down from 53% in 2003, according to Gallup. Partly this is because the economy has faced a devastating recession that the Fed was meant to prevent. But it also reflects discomfort with the Fed's meddling in private markets.

The president went with Mr. Bernanke to keep together two principal architects of the response to the crisis—the other is Mr. Geithner—and to eliminate market suspicions that he wanted a pliable loyalist in the job. In doing so, he has helped assure Mr Bernanke's legacy of making the chairmanship less political and more technical. You might even say academic.[33]

1.3. The International Monetary Fund

1.3.1.1. The Bretton Woods agreement

The International Monetary Fund came into existence in July 1944, *"when representatives of 45 countries meeting in the town of Bretton Woods, New Hampshire, in the northeastern United States, agreed on a framework for international economic cooperation, to be established after the Second World War. They believed that such a framework was necessary to avoid a repetition of the disastrous economic policies that had contributed to the Great Depression."*[34]



In December 1945 the IMF came into formal existence, after the first 29 member states signed its Articles of Agreement. France became the first country to borrow money from the IMF after the fund began its operations on March 1st, 1947.

The IMF's membership expanded until the 1960s but later on, the Cold War limited the Fund's membership, because the countries under the influence of the USSR would not join.

[33] Ibid
[34] http://www.imf.org/external/about/histcoop.htm

The breakdown in international monetary cooperation resulting from the Great Depression of the 1930s, *"led the IMF's founders to plan an institution charged with overseeing the international monetary system—the system of exchange rates and international payments that enables countries and their citizens to buy goods and services from each other. The new global entity would ensure exchange rate stability and encourage its member countries to eliminate exchange restrictions that hindered trade."*[35]

The countries that joined the IMF between 1945 and 1971 agreed to keep their exchange rates (the value of their currencies in terms of the U.S. dollar and, in the case of the United States, the value of the dollar in terms of gold) pegged at rates that could be adjusted only to correct a "fundamental disequilibrium" in the balance of payments, and only with the IMF's agreement. This par value system—also known as the Bretton Woods system—prevailed until 1971, when the U.S. government suspended the convertibility of the dollar (and dollar reserves held by other governments) into gold.[36]

1.3.1.2. The rebirth of the IMF

The Economist believes that after many years of decline of the IMF, the promised $ 500 billion in additional cash and the permission to print $250 billion-worth of its SDR, granted by the G20 meeting held this year, is a sign that the IMF is back shining once again.

Another $100 billion of lending to developing and emerging countries (battered by the speedy exit of foreign capital after years of capital inflows) is supposed to come from the multilateral banks, led by the World Bank.

Where, for example, will the full $500 billion in extra money for the IMF be found? Before the G20 meeting Japan and the European Union had each promised $100 billion and the summit ended with a promise from China of another $40 billion. In the weeks since Canada and Switzerland have each pledged $10 billion and Norway has pitched in with about $4.5 billion. The Indian press reports that the country might contribute $11 billion to the fund, and Brazil has offered $4.5 billion. All together that still leaves the IMF about $220 billion short of the G20's target.

America may have to provide a big chunk of the remainder. Next is the question of what donors might expect in return. Brazil has already said that it wants reforms to how the IMF is run. All the big emerging economies want to see more detailed proposals on changes to voting power within the IMF, and they want the reform process speeded up. (The G20 encouraged the fund to implement the last round of changes, which were agreed in October last year, but did not set a date, which emerging economies will be keen to see announced). A recent suggestion from an IMF reform committee was for a larger role for finance ministers in the daily running of the fund, to give it greater political legitimacy. The idea may be discussed this weekend.

The IMF will also be keen to announce more emerging-economy interest in its Flexible Credit Line, which has now found three takers: Mexico, Poland and Colombia. I will deal with Poland and the FLC later on.

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[35] http://www.imf.org/external/about/histcoop.htm
[36] http://www.imf.org/external/about/histcoop.htm

Another country or two signing up will boost the fund's claim that it is emerging as a credible source of insurance against crises, which is the purpose of its new "no-strings-attached" facility.

For the World Bank, too, much is at stake. It has not been showered with extra funds, but officials say that it has raised lending in response to the crisis, yet is in no danger of running out of money. But some in the institution argue that it should have pushed more aggressively for extra money to fund projects. Some poor countries' finance ministers are expected to raise this issue at the meetings, and call for more capital for the bank. [37]

Pressure may also increase on the bank to push for an early replenishment of the pot of money for the International Development Association, which is then used to fund zero-interest loans and grants to the world's poorest countries. The current pot of $41 billion is supposed to last until 2011, but some argue that an early replenishment will enable more lending to the poorest countries, which the bank has argued are being hit badly by the decline in trade and slowing remittances.[38]

The IMF's managing director, Dominique Strauss-Kahn, turned 60 on April 25th, the same day the fund's steering committee gave its blessing to a proposed tripling of the institution's resources from $250 billion to $750 billion. As the birthday boy is fond of saying: "The IMF is back."[39]

The IMF is notorious for favoring hard money and tight budgets. The new fund ("IMF 2.0" as *Time* magazine called it) believes in casual Fridays and Keynesian policies.

In the Asian financial crisis, the IMF supported punishingly high interest rates to defend the region's currencies and combat inflation. Real rates in Indonesia topped 49% in August 1997 (even before the fund arrived). The aim was to bludgeon speculators and impress creditors. The obvious alternative was to abandon the fight and let the currency fall. That would free the central bank to cut rates. Unfortunately, it would also bankrupt any firms or banks that had borrowed heavily in foreign currency in the belief that the traditional parities were sacrosanct.[40]

It is interesting to see here that the IMF played an active role in the Asian financial crisis, but maybe did more harm than good. Anyhow, I believe that there was no perfect solution to the problem.

More than ten years on, the wisdom of the fund's strategy is still in dispute. (If an economy carries a lot of short-term debt, high interest rates may wreak such havoc that the exchange rate collapses anyway.)

Today's crisis originates with rich-world lenders, not emerging-market borrowers, as Mr Ghosh and his co-authors point out. In my view, this is the opposite of the Bretton Woods Agreement, where the US was the lender, and developing countries the borrowers. Now

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[37] Ibid

[38] Finance & Economics - IMF and World Bank meetings: „Springing into action", From Economist.com, Apr 25th 2009

[39] Economics focus: „New fund, old fundamentals", From The Economist print edition, Apr 30th 2009

[40] Ibid

Asian countries such as China hold the most liquidity in USD and have pumped it in the US determining low cost credit available to anyone. This has hurt the financial market of the US.

Most emerging economies now allow their currencies some freedom of movement. In Latin America and Asia, they have also worked hard to contain currency mismatches, borrowing wherever possible in their own currencies, rather than someone else's. As a result, exchange rates can fall without upending their balance-sheets.

The exception is emerging Europe, which is, in many ways, reliving the Asian financial crisis. Households and companies have borrowed in hard currencies, believing that their exchange rates could only harden against the euro in advance of joining it.

What about fiscal stimulus? In December 1997 the IMF asked South Korea to tighten its belt a notch (a fiscal improvement of 0.4% of GDP). That is now widely seen as a mistake. However, the fund learnt that lesson within a month, urging the Koreans to ignore the fund's own fiscal conditions. [41] In my view, the fact that the IMF stepped back from its own policy is a sign that something has changed, and it seems that it's towards the best.

Where a country has fiscal room for manoeuvre, it should by all means use it, the IMF argues. Mr Strauss-Kahn has welcomed the pronounced fiscal easing undertaken by the world's biggest emerging markets (see chart).

In principle, a dollar of government spending can raise output by more than a dollar if it stimulates resources that might otherwise lie idle. Public investment might also yield rich returns in countries short of infrastructure. But most studies show that fiscal multipliers are small in emerging economies, especially over the medium term. In some cases, they are negative.

As the authors are keen to point out, a fiscal stimulus can do more harm than good if it jeopardizes the sustainability of the public finances. Governments need a credible plan to set aside enough resources in the future to repay the additional public debt their stimulus has added. As Willem Buiter of the London School of Economics puts it, only fiscal conservatives can use counter-cyclical fiscal policy well. [42]

After the increase in its funds by $ 500 mn, "*The International Monetary Fund has been finding more to do in recent months, as various countries—including Hungary, Ukraine,*

[41] Ibid
[42] Ibid

Pakistan and Iceland—have come cap in hand in search of emergency aid. The fund has lent some $50 billion so far, and yet still has about $200 billion in its kitty."[43]

On Tuesday March 24th, 2009, it announced increased borrowing limits on existing loan instruments. It has also rethought the way it monitors how countries fare in meeting conditions attached to its crisis-mitigation loans. But its biggest announcement was that it would create a new lending facility, the "Flexible Credit Line" (FCL). This would allow countries that are suffering from a worsening external environment, but whose macroeconomic policies are generally satisfactory, to draw on money from the fund in a precautionary manner. The idea would be to prevent, rather than mop up after, economic crises. The IMF hopes that this pre-approval feature, and the lack of conditions attached to the loan, will remove stigma that is usually associated with approaches to the fund.

Yet much about the new facility sounds oddly familiar, because it shares many features with a Short-term Liquidity Facility, which it replaces. The IMF unveiled the previous facility with much fanfare at the end of October, around the same time that it made the first big loans to crisis-hit countries. Then the idea was to provide quick, no-strings-attached funding in the early stages of a crisis. As with the new facility, loans were only available to countries which the fund deemed to have sound macroeconomic policies but which were affected by factors outside their control, so to be stigma-free. One would have expected, then, that countries would queue up to be certified eligible for a loan. But it was never used in the five months of its existence.

The IMF says that the problem with the previous facility was that borrowing limits were too low, and repayment periods were too short. The new facility tries to remedy all this by removing borrowing limits and extending loans for longer periods.

The fund argues that it has designed the new facility in consultation with its members, who should therefore be less reluctant to apply for loans. It also points to the eagerness with which the Federal Reserve's precautionary swap lines with some big emerging economies, unveiled in October last year, were taken up.

But critics, while conceding that countries have sought loans elsewhere, point to the fund's particular unpopularity. The reason for this is that most emerging and developing countries see it as unrepresentative and the fief of Europe and America, its largest shareholders. Unless this changes, and by more than the small reforms that are in the works now, the countries that could benefit from new loans will continue to be reluctant to turn to the fund. Some countries such as South Korea, a possible client, have reportedly already said that they are not interested in the new facility. If more countries share the skepticism, the new facility may not be much longer lived or widely used than the one it replaces.[44]
So far, only Mexico and Poland have applied and have been granted FCLs as preemptive measures, not bail-out programs. As I said before, I will deal later on with Poland.

1.3.1.3. SDR: Special Drawing Rights

"Special Drawing Rights, or SDRs, are often referred to as the IMF's currency. Although that is useful shorthand, the SDR is not, in fact, a currency, but rather the IMF's unit of

[43] Finance & Economics – The IMF: „Battling stigma", From Economist.com, Mar 26th 2009
[44] Ibid

account. The value of an SDR is defined as the value of a fixed amount of yen, dollars, pounds and euros, expressed in dollars at the current exchange rate."[45] The necessary money requirements are reviewed every five years to reflect changes in the importance of different currencies in the world's trading system.

SDRs nevertheless represent a potential claim on other countries' freely usable currency reserves, for which they can be exchanged voluntarily. Alternatively, countries with strong external finances can buy SDRs from countries which need hard currency. On April 2nd the G20 countries authorized the IMF to issue $250 billion in new SDRs. The advantage of a fresh SDR issuance is that it immediately augments countries' foreign reserves without needing to be lent.

SDRs are in fact allocated in proportion to countries' existing IMF quotas (see table 3).

This means that around $170 billion of the $250 billion of new SDRs that are to be issued will land in the reserves of rich countries, because they have the lion's share of existing IMF quotas. Still, the increases in the reserves of some emerging economies are not trivial. South Korea's will grow by $3.4 billion, India's by $4.8 billion, Brazil's by $3.5 billion and Russia's by $6.9 billion. Another sign of the instrument's bluntness can be seen from the fact that China's vast reserves, already nearly $2 trillion, will go up by $9.3 billion.

Unfair? 3

IMF votes

	Share, %	
	existing	proposed
United States	16.77	16.73
Japan	6.02	6.23
Britain	4.86	4.29
France	4.86	4.29
China	3.66	3.81
Russia	2.69	2.39
Belgium	2.09	1.86
India	1.89	2.34
South Korea	1.38	1.36
Brazil	1.38	1.72

Source: IMF

Of course, the IMF hopes that some rich countries (or reserve-rich emerging ones) will lend their share of the new SDR allocation to those in greater need. But this is by no means guaranteed. America, for example, needs Congress's approval to part with its share. The last proposed SDR allocation, of $21.4 billion, was approved by the IMF's board in 1997. But although 131 countries with 78% of the total votes in the IMF accepted the proposal, it was never put into effect. Such decisions require 85% support - and America, with nearly 17% of the votes in the IMF, never approved it. [46]

1.4. The Financial Crisis in Europe

According to The Economist *"The economic crisis is still unfolding across the ex-communist world."*[47]

On top of outsiders' neglect and hypocrisy comes abandonment. Having painfully climbed into western clubs after five decades of communist captivity, the most advanced ex-communist countries now feel patronized and excluded. If feckless Greece, stagnant Portugal and overheated Ireland look like going bust, the rich countries of the Euro zone

[45] Special Drawing Rights: „Held in reserve", From The Economist print edition, Apr 8th 2009
[46] Special Drawing Rights: „Held in reserve", From The Economist print edition, Apr 8th 2009
[47] Europe.view: "Insult and penury", From Economist.com, Mar 5th 2009

will bail them out. But the rules for ex-communist countries wanting to join the single currency are arbitrary, and harshly imposed. Lithuania missed Euro zone entry by seven-hundredths of a percentage point. Now Poland and Hungary want accelerated entry into at least the waiting room for the euro, and are snubbed.[48]

In 1999, the Nobel prize for economics was awarded to Robert Mundell, a Canadian economist. *"In a 1961 paper Mr. Mundell had pioneered the theory of an "optimal currency area", a territory suited to adopting a common monetary policy. A main requirement, he concluded, was that workers throughout such an area would be sufficiently inclined to move jobs to even out regional booms and slumps. In later research others added strong trade links, wage flexibility and a central fiscal authority to the list of necessary features."*[49]

Later on, Mundell with Marcus Fleming developed at the IMF the theory of "impossible trinity": *"that a country could not simultaneously have a fixed exchange rate, be open to capital flows and operate an independent monetary policy. It could opt for any two of these features but not all three together. With free capital flows, monetary policy could be directed either at stabilizing an exchange rate or controlling inflation, but not both. A country that targets domestic inflation and is open to foreign capital must have a flexible exchange rate."*[50] As this theory was made public in the beginning of the 1960s, *"most rich countries were tied to the Bretton Woods system of fixed exchange rates. Because capital flows were tightly controlled, countries could set their own interest-rate policies and still keep exchange rates more or less fixed against the American dollar."*[51]

"In principle, a currency adjusts to keep economies in balance, but in practice, argued Mr. Mundell, exchange rates veer wildly from their ideal levels. Large and volatile capital flows mean that floating currencies can be a source of instability. They are also a poor substitute for fully flexible wages and prices.

The benign period ended in the autumn of 2007. The zloty, and some other eastern European currencies, were driven up (see chart 6) as investors piled into emerging markets in the belief that they would soon "decouple" from troubled rich-world economies. A year later, following the collapse of Lehman Brothers, the markets made a U-turn. Capital flooded out of eastern Europe, starving the region of foreign currency and plunging it into a severe crisis.

The financial crisis may have increased the allure of the euro zone, but it has also made it trickier to get in. To join, countries must first meet the "convergence criteria": targets for inflation and public finances, as well as market-based tests for low long-term interest rates and a stable exchange rate (ie, two years in ERM-2). Slovakia made the cut when the criteria were last assessed, in May 2008, and joined in January. Of the eight CEE countries still

[48] Europe.view: "Insult and penury", From Economist.com, Mar 5th 2009
[49] A special report on the euro area: "Fear of floating", From The Economist print edition, Jun 11th 2009
[50] A special report on the euro area: "Fear of floating", From The Economist print edition, Jun 11th 2009
[51] A special report on the euro area: "Fear of floating", From The Economist print edition, Jun 11th 2009

outside, all bar Poland and the Czech Republic missed the mark on inflation, which was supposed to be no more than 1.5 percentage points above the average of the three EU countries with the lowest rate. Poland, for its part, failed to qualify because of doubts that it could control its budget deficit and worries that it owed its low inflation to the rise in the zloty (which was not in ERM-2)[52].

With economies facing a deep recession, inflation is set to drop sharply (though the benchmark for the test is falling too). The public-finance criteria will be far harder to meet. Euro aspirants must show that they can keep their budget deficits below 3% of GDP and cap their debt ratio at 60%. That is tough in a downturn: most countries inside the euro area are already in breach of these rules. But hopes that the rules might be relaxed have been dashed. Those inside the euro fear that easing up on potential entrants would undermine the single currency.[53]

The euro's success so far has suggested that a currency can be stable without the backing of a unitary state. But the financial crisis has raised a fresh question mark over that idea.

It's a fact that the financial crisis has left many governments with their pockets empty. Therefore, it comes as no surprise that they are in urgent need of raising cash. But where does this money come from if not from issuing government bonds? While the US will borrow $1.75 trillion in fiscal 2009, Western European countries may need to raise up to $1 trillion to cover their budget deficits and bank bail-outs.[54] As we will see in Chapter II, Romania too has decided to borrow money from the banks by issuing government bonds.

1.4.1. What has caused the crisis in Europe?

Regarding the causes of the financial crisis in Europe, The Economist has a rather ironic but entertaining approach of presenting the European view on the issue: *"Was it all a conspiracy? It is not the first time in east European history that the question has been asked. Wicked western manipulators were a staple of communist-era propaganda. Before that, anti-Semitic politicians used to blame Jews (and Freemasons) for manipulating the destiny of other countries. In the 19th century, the German, Austro-Hungarian, Czarist and Ottoman empires kept almost the whole region from the Baltic to the Black seas divided up between the great outside powers."*[55]

Now the conspiracy theory is back again. Somebody was spreading rumours. Somebody with foreknowledge or malevolent intent was shorting currencies, stocks and bonds. Someone was using sinister-sounding financial instruments such as credit-default-swaps so that whatever happened, they would profit from a panic. These somebodies could be anywhere, but they are certainly foreign.

The Economist believes that the reasons for the economic crisis are to be found in the fact that financial markets are usually wrong, over-enthusiastic, and based on information that is overly-optimistic and not well documented. The reasoning moves on to ask ironically: *"Was it an outside conspiracy that led supposedly sane Western institutions to lend tens of billions*

[52] The euro: „Currency affairs", From The Economist print edition, Feb 5th 2009
[53] A special report on the euro area: "Fear of floating", From The Economist print edition, Jun 11th 2009
[54] Euro-zone government bonds: „Beating the rush", From The Economist print edition, Mar 5th 2009
[55] Europe.view: „Put the beam before the mote", From Economist.com, Mar 12th 2009

of dollars to Russian companies notable for their weak corporate governance and cash-splattered business models? Was it a western conspiracy that made supposedly sane people buy homes in derelict rural slums in Bulgaria in the belief that it was the new Dordogne? Was it a Western conspiracy that equated the reforms that were promised in the run up to European Union membership with actually making government transparent and efficient?"[56]

Therefore, the reasons for the financial crisis in Europe lie mostly within its boundaries, within its financial markets and within its policies.

1.4.2. What measures have European Governments adopted?

1.4.2.1. Italy

The current economic crisis is expected to have a severe impact on Italy's already fragile public accounts, which will present major challenges for government policy in the medium to long term. So far, international credit rating agencies and the financial markets appear satisfied that the minister of the economy, Giulio Tremonti, is doing enough to avoid a deficit-debt spiral. However, the governor of the Banca d'Italia warns that the economy could be burdened by high levels of taxation for many years to come in order to pay down the rising stock of government debt.[57]

The spread between the interest rate on Italian ten-year bonds and the benchmark German equivalent remains substantially lower than for either Ireland or Greece. As of early June the risk premium on Italy's long-term government debt was around 100 basis points, similar to that of Portugal and just above Spain, but almost half those of Ireland and Greece, which were almost 200 basis points.

However, in a recent speech Mario Draghi, the governor of the Banca d'Italia, warned that even without additional measures to support the economy, the public debt/GDP ratio will have risen by the end of the crisis from around 106% at end-2008 to the high levels of the early 1990s (government debt peaked at about 120% of GDP in 1994-96). He also predicted that as a percentage of GDP, primary current expenditure (excluding interest payments and capital spending), which in 2008 reached its highest level since the second world war, would rise by a further three percentage points in 2009.[58]

Mr. Draghi added that, as a result there was a danger that the Italian economy would be burdened by extremely high levels of taxation for many years to come, which would dampen future economic growth, making it difficult to pay down the government debt. Therefore, he insisted that urgent reforms to cut public spending are fundamental to be able to reduce taxation, improve growth potential and pay down government debt.

The Economist Intelligence Unit expects the fiscal deficit to widen from 2.8% of GDP in 2008 to 5-5.5% in 2009-10, reflecting mainly the impact of a deep and prolonged recession

[56] Europe.view: „Put the beam before the mote", From Economist.com, Mar 12th 2009
[57] Economist Intelligence Unit Briefing: „Debt threat in Italy", From The Economist Intelligence Unit ViewsWire, Jun 19th 2009
[58] Economist Intelligence Unit Briefing: „Debt threat in Italy", From The Economist Intelligence Unit ViewsWire, Jun 19th 2009

on tax revenue. Like its predecessors, the government will also struggle in its medium-term objective of controlling non-interest expenditure, given the political and administrative obstacles to spending cuts. The government debt/GDP ratio is forecast to rise to around 120% by the end of 2010.[59]

The Economist doesn't rule out that Mr. Tremonti might decide to cut taxes, given the coalition's election promise to reduce the tax burden and the weakness of the economy but it doesn't expect him to do so. There is also some concern about Italy's large government debt issuance in 2009 considering that given the current global economic conditions, borrowing costs could be much higher than currently estimated.

1.4.2.2. Poland

Poland's exports account for two-fifths of GDP. Because its exposure to world trade is smaller than that of many other EU countries, it has suffered far less from the global recession. The European Commission reckons its economy will shrink by 1.4% this year, which is not a lot by the dismal standards of the region.[60]

Despite the size and resilience of Poland's economy, its government wants to get into the Euro as soon as possible. It hopes to join the ERM-2 (a pledge to keep the exchange rate within agreed bounds for two years) early next year in order to qualify for euro membership by 2012.[61]

Poland has signed an agreement with the IMF for $20.5 billion one year credit line facility, the newly established IMF Flexible Credit Line (FCL), but this is not a bail-out like those for Ukraine, Hungary and Latvia, but rather a precautionary and unconditional overdraft offered only to top-quality borrowers, as was only the case for Mexico. As a matter of fact, Poland likes to be seen like South Korea and a bit like Mexico, but not like its neighboring countries.[62] The comparison to South Korea is related to the fact that both countries have let their currencies slide, Poland's zloty falling by 30% from its peak value. A senior official in Poland states that "The things that you criticized Poland for in the past are now proving a blessing", referring to the tight monetary policies adopted by the Polish government that prevented an asset-price bubble and to the tough banking regulation that restrained borrowing, especially in foreign currency.[63]

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[59] Economist Intelligence Unit Briefing: „Debt threat in Italy", From The Economist Intelligence Unit ViewsWire, Jun 19th 2009
[60] The euro: „Currency affairs", From The Economist print edition, Feb 5th 2009
[61] Ibid
[62] Poland's economy: „Not like the neighbours", From The Economist print edition, Apr 23rd 2009 | WARSAW
[63] Ibid

The difference from other Eastern European states that have approached and obtained financing from the IMF, is that Poland's $20.5 billion FCL is a precautionary facility that can be drawn without meeting any specific conditions. In order to qualify for such a facility the IMF requires that the following criteria be met: *"a sustainable external position; a good track record of sovereign borrowing; sound public finances; low inflation; sound monetary and foreign-exchange policies; and a fundamentally healthy banking system."*[64]

There are other Eastern European countries have *relatively low levels of public debt, unthreatening debt-repayment profiles and reasonably healthy banking systems. These countries are the Czech Republic, Slovenia and Slovakia. "In these respects, their position is sounder than that of most of their neighbours to the east—the Baltic states, Hungary, Ukraine, Romania, Bulgaria and the western Balkan states."*[65]

The Polish government's worst case forecast is of a rise in GDP this year of 1.7%. Neil Shearing of Capital Economics thinks GDP is more likely to fall by 3%. Unemployment, swollen by returning migrants from Western Europe, is already 11.2%. Exports have stalled. Industrial production in the first quarter was down by a tenth on a year ago. Ill-considered currency hedges have hit some firms. Tax revenues are sagging. The government's efforts to prepare for euro entry by 2012 look "fairly futile", says Mr. Shearing. He thinks 2015 is more realistic.

Unlike others in Eastern Europe, Poland's government is strong and stable. But its main contribution, says Marcin Piatkowski, a former IMF economist now at Warsaw's Kozminski Academy, has been "brilliant PR". Downplaying the crisis has been good for confidence, but doesn't help promote much-needed reforms, he notes. One such is of bureaucracy: Poland comes 76th in the World Bank's ranking for ease of doing business, below Kazakhstan. Mr Rybinski calls this "shameful".[66]

The size of the loan that Poland has applied for supports the government's vehement insistence that it is not a basket case. At US$20.5bn, the mooted facility is equal to just 3.8% of 2008 GDP. By contrast, Hungary's US$25bn IMF and EU aid package is equal to 16.2% of GDP; Ukraine's US$16.4bn loan equals 8.9% of GDP; and Serbia's €3bn (US$4bn) loan amounts to 7.9% of GDP. Moreover, it is far from certain that Poland will actually draw the facility.[67]

It seems that Poland's intentions when approaching the IMF for the FCL have been to support its currency, the zloty, and it seems to have achieved just that: *"the zloty, which not so long ago was trading at close to Zl 5:€1, firmed to Zl 4.3:€1 on news of the IMF approach."*[68]

The Economist believes that all things considered, *"the FCL application looks like a prudent step, giving Poland a fallback option should it find credit markets difficult to tap later in the year; and in the meantime, for this reason, it might offer some respite for the zloty."*[69]

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[64] Economist Intelligence Unit Briefing: "Credit for Poland", From The Economist Intelligence Unit ViewsWire, Apr 16th 2009
[65] Ibid
[66] Ibid
[67] Ibid
[68] Economist Intelligence Unit Briefing: "Credit for Poland", From The Economist Intelligence Unit ViewsWire, Apr 16th 2009
[69] Ibid

1.4.2.3. Denmark

"Denmark's currency is pegged to the Euro but the country remains outside the Euro zone after twice failing to secure a popular vote in favor of joining. It has the worst of all worlds. The currency peg is open to speculative attack, so its exchange-rate stability is precarious; yet to preserve it, the country has had to sacrifice an independent monetary policy. The government has been mulling a third referendum but the new prime minister, Lars Lokke Rasmussen, said in April that it would not take place this year."[70]

The Danish central bank has warned the government that given the rapid deterioration in the public finances, it would be imprudent to consider any additional fiscal easing in addition to that already agreed. Highlighting the country's deteriorating international competitiveness, the bank also urged reforms aimed at permanently increasing the labour supply. But with unemployment now rising, far-reaching labor market reforms will remain elusive. Instead, the government is emphasizing tax cuts and increases in public spending to alleviate the effects of the downturn, with its zeal for large-scale infrastructure investment projects seemingly unaffected by current fiscal pressures.[71]

The report is not shy in implicitly criticizing the government's expansionary fiscal policies during the economic upswing in 2004-07, noting that this helped fuel high wage growth and a loss of export competitiveness. Since 2000, Denmark's international competitiveness has deteriorated by around 25-30%, according to the National bank's own calculations. In addition to strong wage increases, other factors that weigh on competitiveness include a strong effective, or trade-weighted, krone exchange rate and weak productivity growth.[72]

The Review points out that as a result of the economic boom, unemployment fell to a level significantly below its structural rate (consistent with stable wages and prices), which is estimated to be between 100,000 to 120,000 people. The Bank suggests that for wages to fall to a more appropriate level and restore Denmark's competitiveness would require either that unemployment remains above its structural level for a prolonged period, or that the government pursues reforms to permanently increase the labour supply.[73]

The Danish government has so far employed a range of measures aimed at alleviating the economic effects of the financial crisis and global downturn. These have included tax cuts—personal income taxes have been lowered, with the government recently securing parliamentary agreement for a further phased reduction in 2010-11—and support for the banking sector, including state guarantees for lending and the provision of up to Dkr63bn (US$11.5bn) to recapitalise the financial system. Reforms are now being considered to ensure that creditworthy companies have sufficient access to financing in still-constrained credit markets.[74]

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[70] A special report on the euro area: "Fear of floating", From The Economist print edition, Jun 11th 2009
[71] Economist Intelligence Unit Briefing: "Exit strategy", From The Economist Intelligence Unit ViewsWire, Aug 17th 2009
[72] Ibid
[73] Ibid
[74] Ibid

1.4.2.4. Iceland

Of all the European region states, one of the most affected by the global financial crisis is Iceland. *The Icelandic government has formally requested a US$2bn loan from the International Monetary Fund (IMF), three weeks after the state was forced to take control of the country's three largest commercial banks.*[75]

The international credit crisis hit Iceland hard in mid-September, as credit markets seized up almost completely following the bankruptcy of Lehman Brothers, the US investment bank (a move now widely viewed as having precipitated the current acute financial crisis). The IMF sent a fact-finding mission to Iceland in early October, just as the country's third largest bank, Glitnir, was taken into government hands. It soon became evident that the problems facing the Icelandic financial system were larger than the state could conceivably handle on its own. However, the government was far from keen for Iceland to become the first western country to receive IMF assistance since the UK in 1976 and accept its position as the first sovereign victim of the international credit crunch.

By the middle of October, however, external assistance was widely seen as the only possible option after the government had been forced to take over the country's three largest banks with liabilities totaling more than 10 times Iceland's annual GDP. The near-collapse of the financial system caused a 90% drop in the domestic stock market, extensive problems for money market funds, the evaporation of more than one-third of the value of the national pension system and a nearly uncontrollable depreciation of the Icelandic krona (before the Central Bank imposed currency controls after two days of unsuccessful attempts to defend the currency). Outside of Iceland the krona became almost worthless, trading 80% below its value in domestic markets.

Exporters have been unable to transfer funds into Iceland after the country's payment system collapsed, leading to severe losses in terms of market access and the development of a currency black market.

The severe vulnerability of the financial system became evident following a speculative attack in March 2008 and the collapse of Lehman Brothers in the US, which triggered a sharp flight to safety among global investors. The Central Bank began at that time to seek currency swap agreements with the European Central Bank, the Bank of England and the US Federal Reserve in addition to the Nordic Central Banks. These overtures resulted only in a €1.5bn swap facility agreement with three Nordic central banks, as the world's major central banks all declined to provide assistance. This prompted the Icelandic prime minister, Geir Haarde, to state that the country was now forced to look for "new friends".[76]

On October 7th the Central Bank of Iceland announced that it was in negotiations to receive a €4bn loan from Russia to strengthen its foreign currency reserves. Even though an agreement ultimately wasn't reached, the Russian advance caused a stir in the Nordic countries and pushed the Icelandic problem higher on the international political agenda. Using the threat of increased Russian influence in Iceland has been a tried-and-tested method used repeatedly by Iceland (mainly during the Cold War) to influence US and NATO policies.

[75] Economist Intelligence Unit Viewswire: "Cool aid?", From The Economist Intelligence Unit ViewsWire, Oct 28th 2008

[76] Ibid

The US$2bn loan provided by the IMF is set to be accompanied over the next four years by additional loans totalling around US$4bn from its Nordic neighbours, and possibly also Japan, which announced earlier this month that it would use some of its US$1trn foreign reserves to support IMF programmes to strengthen the international financial system.

The total package of around US$6bn equates to around 50% of Iceland's annual GDP (in purchasing power parity terms) or over 11 times the country's IMF quota. This is a much larger assistance programme, in relative terms, than both Turkey and Brazil received earlier this decade.

In addition, large amounts of government guaranteed bonds will have to be issued to refinance the banking system and recapitalise the Central Bank of Iceland.

Over the coming years Iceland's economic policy will be planned in collaboration between the government and the IMF.

The IMF has also stepped back from demanding the privatisation of the state-owned Housing Financing Fund, despite urging such action in its previous recommendations. However, tighter monetary policy will be required to support the currency and prevent capital flight once the krona is refloated. Considerable currency volatility is expected in the short term.

The IMF programme is just the first step for the Icelandic economy towards regaining credibility in international markets, rebuilding the payments system and restoring capital flows and an effective currency market.

Moreover, EU membership is now increasingly viewed in Iceland as an important step towards strengthening the country's international standing, regaining confidence in foreign markets and rebuilding a stronger and more robust economic and financial system.

1.4.3. The changing roles of the Central Banks

Andrew Smithers, a British economist, that is the co-author of the book "Valuing Wall Street", appeared in 2000, approaches once again the theme of stockmarket valuation. He argues that *"it is not only possible to ascertain a fair value for stock markets but that central banks should try to do so and adjust their policies accordingly."*[77] Mr. Smithers likes to believe that markets are "imperfectly efficient", in other words, that they fluctuate around their fair value.

Andrew Smithers, argues that central banks should use the valuation data to decide whether stock markets are over-extended, and they should look at house prices and the price of liquidity.

Contrary to past beliefs that the central banks should clean up the mess caused by burst bubbles instead of popping them, Mr. Smithers believes *"that the aim of central banks should not be to avoid an occasional mild recession but a big downturn, such as the world has been suffering."*[78] They could achieve this not by increasing interest rates but changing

[77] Valuing stock markets: "When the signals flash red", From the Economist print edition, Aug 13th 2009
[78] Ibid

the capital ratios of banks, by requiring banks to hold more capital which would slow the flow of lending and diminish the fuel for speculation.[79]

In the world that existed before the financial crisis, central bankers were triumphant. They had defeated inflation and tamed the business cycle. And they had developed a powerful intellectual consensus on how to do their job, summarized recently by David Blanchflower, a member of the Bank of England's monetary policy committee, as "one tool, one target". The tool was the short-term interest rate, the target was price stability.[80]

This minimalist formula fitted the laissez-faire temper of the times. A growing array of financial markets could price risk and allocate credit efficiently. Central bankers had merely to calibrate their interest-rate tools and all other markets would automatically adjust. Central banks still cared about financial stability and full employment, but could argue these were best served by stabilizing prices—without, if you please, interference from politicians.

More fundamentally, the collapse of stable relationships in financial markets has forced central banks to make judgments they once left to the private sector. From lenders of last resort, they became lenders of first resort when banks stopped trusting each other. They are, increasingly, arbiters of which types of borrowers get credit. With the reputation of market discipline in tatters, central bankers will get vast new supervisory powers. All this is dragging central banks back towards political turf from which they had been distancing themselves for years.

Central bankers still believe that once the crisis has passed they will return to their pre-2007 roles as apolitical technocrats pulling a single lever and eyeing a single variable. It may be a vain hope. "When you question the basic premise which you have worked under for the last 15 to 20 years, which is that markets are rational and efficient, there is a case for a different [81]approach to both monetary policy and regulation," says Thomas Mayer, chief European economist of Deutsche Bank.

Eric Rosengren, president of the Federal Reserve Bank of Boston, noted recently that the Fed has hit, or all but hit, the zero limit twice this decade. That is more often than earlier simulations had indicated—and it suggests higher inflation targets should be considered. Another proposal is that central banks aim at a path for the price level rather than the inflation rate. Suppose that this path rose by 2% each year. Then after deflation of 1% in year one, the central bank would aim for inflation of more than 2% in later years (inflation of 5% in year two, say) to bring prices back up to the target. Greg Mankiw, a Harvard University economist, goes further, suggesting that inflation simply be given lower priority. "There are worse things than inflation," he says. "We have them today."[82]

I will talk in chapter two of the role that the National Bank of Romania has adopted in reaction to the economic crisis.

1.4.4. Getting out of the crisis

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[79] Ibid
[80] Central banks: „The monetary-policy maze", From The Economist print edition, Apr 23rd 2009 | WASHINGTON, DC
[81] Ibid
[82] Ibid

Anglo-Saxon skeptics about Europe's single currency gleefully predict that these strains will blow the euro apart, just as they did the exchange-rate mechanism in the early 1990s. Yet even if some countries now have a twinge of regret over joining the euro, they know that the pain would get worse still if they left. Quite apart from the huge technical problems of reintroducing a national currency, quitting the euro would surely entail default on euro-denominated debts, and could also put a country's membership of the European Union at risk.[83]

Yet if leaving the euro is unthinkable, the risk of default by a country that stays in has clearly gone up. As more countries from central and Eastern Europe join, that danger is likely to rise further. This suggests that it would be sensible to draw up contingency plans for how the rest of the euro area should best respond to a threatened or actual default.

The rules of the single currency expressly forbid any bail-out of one country by the centre or by other countries. The Germans, ever fearful that they may be asked to pick up the bill for the profligacy of others, are already squashing any talk of issuing joint euro-area bonds to relieve some of the pressure on national governments. Yet as the euro area's biggest economy and biggest exporter, Germany would suffer more than most from any member's default. So it has a huge stake in making sure it does not reach that point.

That need not imply a straightforward bail-out. But it does suggest the euro area might need an equivalent of the International Monetary Fund's rescue packages. It would imply both a bigger role for the centre and more intrusive monitoring of euro members' budgets. Far from fulfilling the Euro skeptics' dream of kyboshing the entire European project, a crisis could thus lead to even deeper political integration. That is a guess. But some form of euro drama looks ever more likely - and it would be better if governments started preparing for it now. [84]

At the beginning of June Jean-Claude Trichet, the head of the European Central Bank, set out its latest forecasts. Though the worst of the downturn had probably passed, he said, the euro-area economy would be unlikely to grow until the middle of 2010. Just a few weeks later Mr Trichet looks too gloomy. Figures published on August 13th are likely to show that GDP shrank again in the second quarter, but that this will probably be the low point.

More timely indicators suggest the economy has started to grow again. Businessmen are cheerier. The gauge of German business sentiment published by Ifo, a research institute in Munich, rose in July to its highest level for seven months. Confidence in France increased for a fourth straight month, according to a survey by INSEE, the national statistics agency. The brighter mood reflects orders and sales. Euro-zone industrial output rose in May for the first time since September. A broader index, based on surveys of purchasing managers in manufacturing and services, was much stronger in July.[85]

1.4.5. The drop in tax revenues

A Beatles song "Taxman" went like this "If you drive a car, I'll tax the street/ If you try to sit, I'll tax your seat."[86] The tax thirsty European and US governments might actually think

[83] The euro: „High tensions", From The Economist print edition, Feb 5th 2009
[84] Ibid
[85] The euro-area economy: "First, the good news", From the Economist print edition, Jul 30th 2009
[86] Buttonwood: "Be thankful they don't take it all", From The Economist print edition, Sep 3rd 2009

of this when figuring out how to raise more money from its citizens and companies in the form of taxes.

Even if a *"European Commission report published earlier this year concluded that tax-revenue growth was "exceptionally high" in most European Union countries during the period from 2003 to 2007."*[87], many European governments found even more ways of spending the money raised for gaining political capital for instance. Instead, these governments should have stored surpluses when the times were good, for bad times.

One would ask what caused such a high fluctuation in tax revenues, from boom to bust. The answer may be found in the fabulous growth in asset prices, which in turn generated higher tax revenues. Considering that America and Great Britain's tax revenues come in great part from property taxes, even more than other countries, it comes of no surprise that a big fall in asset prices determines an equivalent drop in tax revenues.

Yet another factor might be that consumers increased their spending, given the fact that it was quite easy to get financing up to the moments the crisis started. However, those consumers now find it difficult to repay their debts, let alone apply for more financing.

Until now, both Great Britain and the US have been cashing in on revenues from the finance industry, revenues which now have vanished. Considering that unemployment is soaring, more pressure is put on social security, which was already strained before the crisis. In the previous years, the banker's bonuses were one good source of revenue, but now, considering the demonization of this practice, it may take a long time for governments to see that level of tax revenue.

Taking into account the drop in tax revenues, more pressure is put on governments to cut waste in public spending, a very unpopular measure, given the fact that many public sectors were already in need of financing under normal circumstances. Therefore, countries will have to be inventive in finding other things to tax.[88]

According to The Economist: *"Because governments are limited in their ability to tax the mobile, they will tax the static. As noted above, property is already highly taxed in Britain and America (and may be years away from another boom). So consumption taxes are the more likely answer. They are hard to avoid and fairly stable, since spending patterns do not change sharply from year to year. But they tend to fall more heavily on the poor than the rich. A crisis created by investment bankers will be paid for by shop assistants and office cleaners."*[89]

1.4.6. European Banks Bailouts

The Economist points out that *European Union leaders have rejected calls for a special €180 billion ($229 billion) rescue fund for ex-communist countries in east and central Europe. Leaders gathered in Brussels on Sunday March 1st for an emergency summit to discuss the economic crisis dismissed suggestions, led by Hungary, that a single plan was needed to save the region. Without massive help for ex-communist nations, Hungary's prime*

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[87] Ibid

[88] Buttonwood: "Be thankful they don't take it all", From The Economist print edition, Sep 3rd 2009

[89] Buttonwood: "Be thankful they don't take it all", From The Economist print edition, Sep 3rd 2009

minister, Ferenc Gyurcsany, had said, a "new Iron Curtain" risked splitting the continent anew.

But Angela Merkel, the German chancellor, squashed talk of a dedicated plan for eastern Europe, saying the ten ex-communist countries in the EU faced "very different" degrees of peril in this economic crisis. It was ill-advised to throw "massive figures" around, added Mrs Merkel. Hers is a voice that counts: Germany pays more into EU coffers than any other nation.

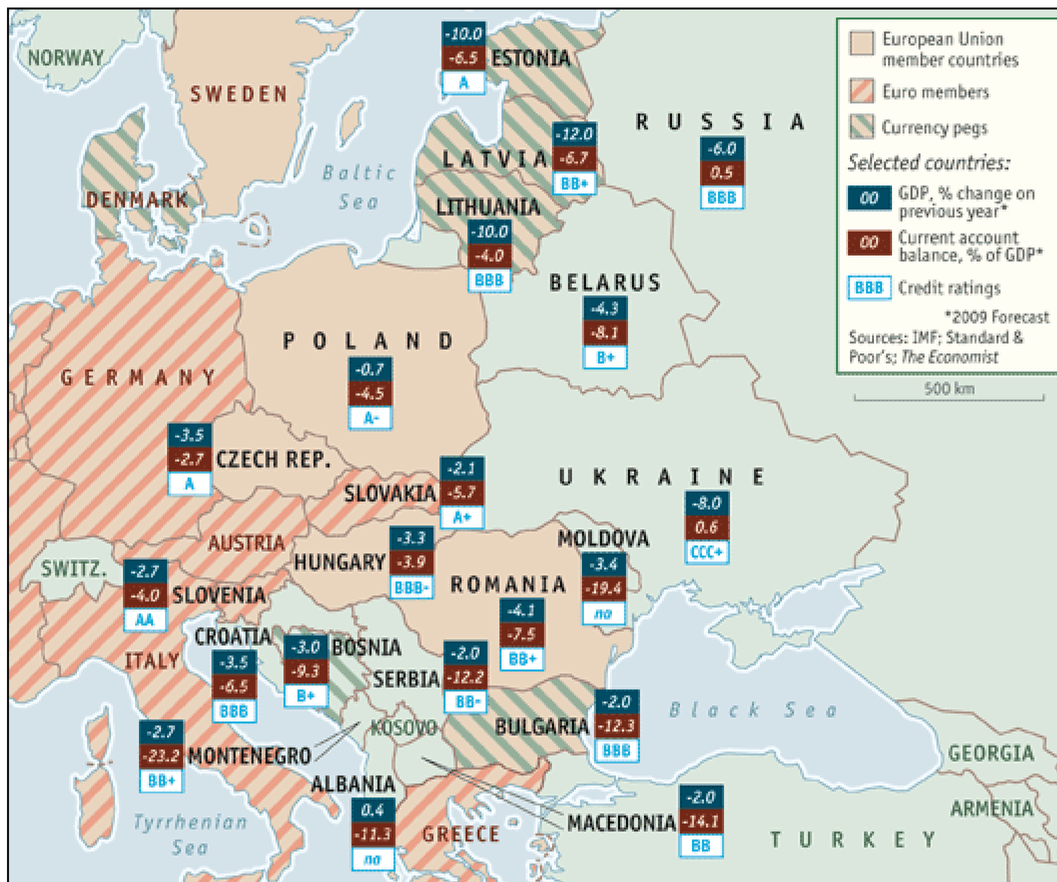
In Brussels, it was seen as highly significant when German ministers signaled last month that they might be prepared to step in to prevent a country defaulting within the 16-member group that shares the single currency. But a dedicated bail-out for the ten ex-communist countries that have joined the EU since 2004 is clearly a step too far. Germany will hold federal elections later this year, and voters there are acutely sensitive to suggestions that Germany and other rich nations should bail out weak or profligate members of the European club.[90]

In my view, Germany is very sensitive to European policies that involve its financial support. Many Germans believe that Germany is carrying the burden of other lazier European countries such as Italy.

The idea of a single money as a path to European political union goes back a long way. In the 1950s a French economist, Jacques Rueff, wrote that "Europe shall be made through the currency, or it shall not be made." But the euro had pragmatic roots too. After the breakdown of the Bretton Woods system of fixed exchange rates in 1973 the Deutschmark emerged as the benchmark currency in continental Europe.[91]

[90] The European Union: „Ailing in the east", From Economist.com, Mar 1st 2009 | BRUSSELS
[91] A special report on the euro area: "A tortuous path", From The Economist print edition, Jun 11th 2009

1.4.7. The present and the future of the EU economy



Thanks to a mix of luck and good decisions, the economic apocalypse that loomed over *central and Eastern Europe seems to have been averted. But dizzy current-account deficits, wild foreign-currency borrowing and reckless fiscal policy are leaving a horrible hangover for some. The IMF forecasts a 4.9% average fall in GDP, with far bigger falls for some. The European Bank for Reconstruction and Development (EBRD) reckons on a 5.2% drop. The downturn is certainly nasty; but some changes have staved off the worst.*

One change is that outsiders now assess risk more calmly and rationally. All the former planned economies remain capital-thirsty. But otherwise they are all different.

Exchange-rate regimes vary: two countries are in the euro; five countries have pegged their currencies to it; others float. [92]

If businesses converted their debts to a weaker currency, that might constitute default and trigger legal challenges. If they stuck to their covenants, they would have to service their euro debts from earnings in a weaker currency. That would hurt firms which rely mostly on profits from their domestic market. The convulsions would be felt by other euro-area members too. The write-down of the departing country's government bonds might threaten the solvency of banks in the rest of the euro zone. Around half of Italian government bonds,

[92] Central and Eastern Europe: "No panic, just gloom", From the Economist print edition, May 14th 2009

for instance, are held outside Italy. Other euro-area members could suffer contagion as markets bet on further defaults. [93]

An exit from the euro would not tackle weak productivity growth and inflexible wages, which are the root causes of low competitiveness. In time, further devaluations might be needed. Countries with high debts and a history of poor macroeconomic management would be most tempted to leave. But these are also the countries most likely to be hurt.

A more plausible, though still unlikely, scenario would involve a breakaway by a group of low-debt and cost-competitive countries, centred around Germany. Members of a new, "hard" European currency would leave behind a stock of depreciating euro debt and might be rewarded by lower borrowing costs on debt issues in the new currency. Yet a large part of the appeal to Germany of the single currency has been that it rules out revaluations and rewards its firms for being competitive. Germany, France and the rest have too much invested in the success of the EU and the euro to put it at risk. As Daniel Gros of the Centre for European Policy Studies, a Brussels think-tank, puts it: "The weak can't leave and the strong won't leave."[94]

In my view, the exit from the euro zone is not a viable solution due to the fact that even developed countries such as Germany benefit to a certain extent from cheap labour coming from Eastern Europe and as Daniel Gros puts it, Germany has invested already too much in the success of the EU and the Euro.

1.5. The Financial Crisis in Asia

1.5.1.1. How has Asia dealt with the present crisis?

In Asia, a solution to preventing bubbles and strengthening domestic spending—is to allow exchange rates to rise. If Asian central banks stopped piling up reserves to hold down their currencies, this would help stem domestic liquidity. Stronger currencies would also shift growth from exports to domestic demand and increase households' real spending power—and help ward off protectionists in the West.

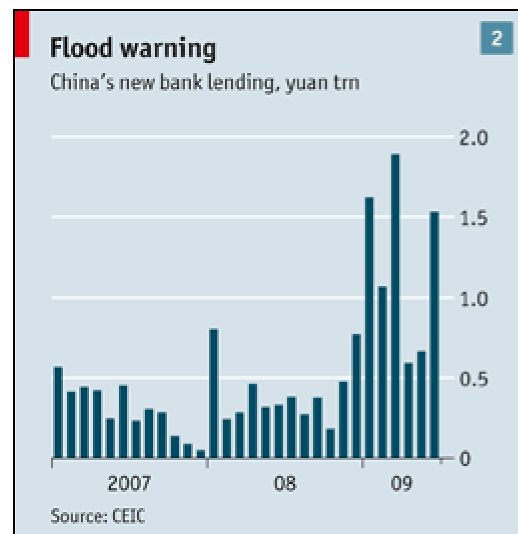
The tigers' faster-than-expected rebound from their 1997-98 financial crisis encouraged complacency and delayed necessary reforms, which left them more vulnerable to the global downturns in 2001 and now. [95]

[93] A special report on the euro area: "No exit", From The Economist print edition, Jun 11th 2009
[94] Ibid
[95] Emerging Asian economies: "On the rebound", From The Economist print edition, Aug 13th 2009 | HONG KONG

1.5.1.2. China

As I was saying earlier, GDP growth performance is different from one country to another. China for instance, grew at an annualized rate of 16.5% in the second quarter compared with the previous three months, according to Goldman Sachs estimates (as seen in chart 1 above). On July 16th new figures showed China's GDP growth quickened to 7.9% in the year to the second quarter.

Compared to the US, China's economic stimulus has been so effective that some economists are now worrying it may be working rather too well.



In the year to June fixed investment surged by 35%, car sales rose by 48%, and purchases of homes by more than 80%. After falling last year, home prices are now rising briskly in some big cities, and share prices have soared by 80% from their November low. Domestic spending has been spurred partly by the government's stimulus package, but probably even more important was the scrapping of restrictions on bank lending late last year. In June new lending was more than four times larger than a year earlier (chart 2)[96].

China's economy recovered so fast because the slowdown in the economy was self-inflicted, rather than the result of America's economic collapse. In 2007 the Chinese government feared that the economy would overheat, and as a result curbed the flow of credit for construction and home buying. As a result, the economy slowed down abruptly even before the global financial crisis. In November 2008, the Chinese government pushed the credit throttle to full power. *"That has given a big boost to domestic spending but raised concerns that the flood of liquidity will push up inflation, fuel bubbles in shares and housing, and store up bad loans."*[97]

Several officials at the central bank have said lending should be curbed.

The prime minister, Wen Jiabao, is signalling that he wants monetary policy kept fairly loose.

The central bank has slightly increased money-market interest rates and warned banks that it intends to increase its scrutiny of new bank loans. The China Banking Regulatory Commission has warned banks to stick to rules on mortgages for second homes, which require a down-payment of at least 40% of a property's value.

The strategy of the Beijing government is to use property as a way to spur private consumption because higher house sales encourage more spending on furniture and

[96] China's recovery: "A fine balancing act", From The Economist print edition, Jul 16th 2009 | HONG KONG
[97] China's recovery: "A fine balancing act", From The Economist print edition, Jul 16th 2009 | HONG KONG

consumer appliances and construction also creates lots of jobs. To achieve this, in Octover 2008, the government has encouraged people to buy houses by cutting the minimum mortgage down-payment on their main home from 30% to 20% and by reducing stamp duty and other taxes on property transactions. [98]

Despite the recent lending boom, Chinese banks' mortgage lending is still very conservative compared with that in America—at the peak of America's housing bubble it was easy to get a mortgage for 100% or more of the value of a home. Nevertheless, the lesson of America's financial crisis for China's government is plain: overly loose lending should never be ignored.[99]

Comparing the second quarter with the first at an annualized rate, China's GDP grew by 15%, South Korea's by almost 10%, Singapore's soared by 21% and Indonesia's managed a respectable 5%

Asia's bounce has taken many forecasters by surprise. In May, for example, the IMF predicted that Asia's recovery was likely to be "tepid" because the developed economies—and hence demand for Asian exports—would remain weak. Forecasters always seem to underestimate the ability of the Asian tigers to rebound from recessions.

It was true that Asia's strong growth had concealed wasteful investment, inadequate bank regulation and corruption, but the key ingredients of growth—rapid productivity growth, relatively open markets and a high saving rate to finance investment—remained in place. That helps explain why the East Asian economies recovered more quickly than many expected.[100]

Asian households are not burdened with huge debts, so tax cuts or cash handouts are more likely to be spent than saved. It is also easier in a poorer country to find worthwhile infrastructure projects - from railways to power grids - to spend money on.

In China the easing of credit has been even more important than its fiscal stimulus.

Mike Buchanan, an economist at Goldman Sachs, has raised his forecast for GDP growth in emerging Asia to 5.6% for 2009 as a whole and 8.6% in 2010. He expects China to grow by a breathtaking 9.4% this year and 11.9% next.

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[98] China's recovery: "A fine balancing act", From The Economist print edition, Jul 16th 2009 | HONG KONG
[99] China's recovery: "A fine balancing act", From The Economist print edition, Jul 16th 2009 | HONG KONG
[100] Emerging Asian economies: "On the rebound", From The Economist print edition, Aug 13th 2009 | HONG KONG

After falling last year, house prices are now rising rapidly in Hong Kong, Shanghai, Seoul and elsewhere. Home sales have surged by 70% in value in China over the past year. According to one estimate, one-fifth of all new lending this year in China has gone into the stockmarket or property.

Asia's monetary conditions are too loose now that economies are reviving; central banks need to raise interest rates. But with rates close to zero in the rich world, and likely to stay there for a while, this would lure in foreign capital, adding to domestic liquidity. Capital is already rushing in, attracted by the region's growth, which is faster than the rest of the world's.

The basic problem is that although the Asian economies have decoupled from America, their monetary policies have not. In a world of mobile capital, an economy cannot both manage its exchange rate and control domestic liquidity. By trying to hold their currencies down against the dollar Asian economies are, in effect, being forced to shadow the Fed's monetary policy even though their economies are much stronger.

The obvious solution is to let exchange rates rise, but with exports still well below last year's level, governments are reluctant to set their currencies free.

Several central banks in the region, including the People's Bank of China, the Bank of Korea and the Hong Kong Monetary Authority, have given warnings about the risk of asset bubbles. But there is unlikely to be any significant policy tightening before next year, because boosting growth remains governments' main priority.

Its credit boom is clearly unsustainable, but China is unlikely to hit the monetary brakes until inflation turns positive and its year-on-year GDP growth tops 10%. Instead, policymakers will try to contain the bubble by tightening lending standards.

In the longer term, Asia's growth needs to come more from domestic demand rather than exports.

In Indonesia, Malaysia, the Philippines, Taiwan and Thailand it is instead investment that looks too low. Investment as a percentage of GDP is little higher than in many rich economies, even though investment opportunities in a developing country should be far greater. For example, Malaysia's investment has fallen from 43% of GDP in 1997 to only 19% last year, less than in the euro area or Japan and well below China's 44%. Weaker investment is one reason why the trend growth-rates of some Asian economies have slowed over the past decade.

Although China's goal should be to consume more, some of the other Asian economies need to invest more. That will require an improved regulatory environment, a crackdown on corruption, better infrastructure and—not least—greater political stability.

To lift private consumption, governments therefore need to increase households' share of national income by encouraging more labour-intensive services, rather than favouring capital-intensive manufacturing industries with subsidies and undervalued exchange rates.

The gap between growth rates in emerging Asia and the G7 is forecast to rise to a record nine percentage points this year (see chart 4). But what does the future hold? Pessimists argue that Asia's growth over the coming years will be much slower than before the global crisis because its main engine of growth, exporting to America, has broken down and it will take years to find a replacement. But this may overstate the importance of America to the Asian tigers. Between 2001 and 2006 (when America's trade deficit peaked), the increase in emerging Asia's trade surplus with America accounted for only 6% of the region's GDP growth. If those exports cannot be replaced by domestic demand, growth will be slower, but not massively so.

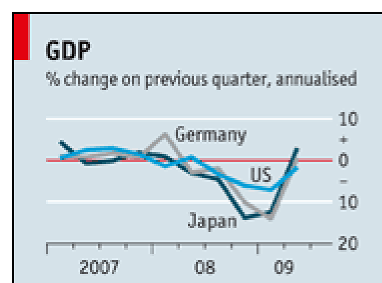
In America and many other rich countries, by contrast, potential growth rates are likely to fall over the next decade as soaring government debt and hence higher taxes blunt incentives to work and invest, the lingering credit crunch dampens investment, and increased government regulation deters innovation.

Emerging Asia as a whole might enjoy annual growth of 7-8% over the next five years, at least three times the rate in the rich world. The sharp downturn in Asia late last year painfully proved that the region was not immune to America's downfall. But the speed and strength of its rebound, if sustained, show that it is not chained to Uncle Sam either. If anything, the crisis has reinforced the shift of economic power from the West to the East.

1.6. How is the world economy doing

1.6.1. Recovery

The worst global recession since the 1930s may be over. Led by China, Asia's emerging economies have revived fastest, with several expanding at annualised rates of more than 10% in the second quarter. A few big rich economies also returned to modest growth, between April and June 2009. Japan's output rose at an annualized pace of 3.7%, and both Germany and France notched up annualized growth rates of just over 1%. The housing market in the US has shown signs of stabilizing, the pace of job losses is slowing and the vast majority of forecasters expect output to expand between July and September. However, most economies are still a lot smaller than they were a year ago.



This is good news. The first step in any recovery is for output to stop shrinking. But the more interesting question is what shape the recovery will take. The debate centres around three scenarios: "V", "U" and "W". A V-shaped recovery would be vigorous, as pent-up demand is unleashed. A U-shaped one would be feebler and flatter. And in a W-shape, growth would return for a few quarters, only to peter out once more.

As we will see in the next chapter, Mugur Isărescu, the governor of the National Bank of Romania, believes that the financial crisis in Romania is V-shaped.

Optimists argue that America's deepest post-war recessions, were followed by vigorous recoveries. In the two years after the slump of 1981-82, for instance, output soared at an average annual rate of almost 6%; and this time round, output has slumped even further, and for longer, than it did in the early 1980s.[101]

Pessimists, think this downturn's origins favor a weak recovery or a double-dip. Unlike typical post-war recessions this slump was spawned by a financial bust, not high interest rates, and when over indebted borrowers need to rebuild their balance-sheets and financial systems need repair, growth can be weak and easily derailed for years. Japan's 1990s banking crisis left the economy stagnant for a decade; a premature tax increase in 1997 plunged it back into recession.[102]

However neither the optimistic nor the pessimistic views are applicable to today's global slump because it combines several types of downturn and an unprecedented policy response. In formerly bubble economies, it is largely a balance-sheet recession. Debt-fuelled consumption has been felled. But the scale of collapse was broadened and deepened by the freezing up of the machinery of global finance, a dramatic collapse in confidence and stock-slashing. It was then countered with the biggest stimulus in history. The shape of the recovery depends on how these forces interact.

In the short term that shape could look beguilingly like a "V", as stimulus kicks in and the inventory cycle turns. In emerging Asia, the unfreezing of trade finance, a turnaround in stocks and hefty fiscal stimulus are powering a rebound. Government support, especially employment subsidies and incentives toa buy new cars, has cushioned demand in Germany and France. With export orders rising and confidence growing, the next few months could be surprisingly buoyant. [103]

Even if housing stabilizes, consumer spending will stay weak as households pay down debt. Real V-shaped recoveries are better in emerging economies, especially China (and I would say also to Romania). But even there an array of reforms, from a stronger currency to an overhaul of subsidies, is needed to boost labor income and encourage consumption. Until that shift takes place, the global recovery will be fragile and probably quite feeble. A gloomy U with a long, flat bottom of weak growth is the likeliest shape of the next few years.[104]

Mr. Justin Lin, the chief economist at the World Bank, believes that low-income countries need to make small, local banks the mainstay of their financial systems.

What matters most is setting up a financial sector that can serve the competitive sectors of an economy. In many poorer countries, that means focusing on activities dominated by small-scale manufacturing, farming and services firms. The size and sophistication of financial institutions and markets in the developed world are not appropriate in low-income markets. Small local banks are the best entities for providing financial services to the enterprises and

[101] World economy: "U, V or W for recovery", From The Economist print edition, Aug 20th 2009
[102] Ibid
[103] Ibid
[104] Ibid

households that are most important in terms of comparative advantage—be they asparagus farmers in Peru, cut-flower companies in Kenya or garment factories in Bangladesh.

The rise of the New York Stock Exchange occurred only after the creation of large-scale industrial firms at the close of the 19th century. For the early labour-intensive phase of America's economic development, local banks were dominant.

Governments and the international financial institutions that help them should resist the temptation to strive for "modern" stockmarkets in the early stages of a country's development.

Microfinance companies and other non-bank financial institutions will play a more important role in financing poor households. And stockmarkets are not the best conduit for providing finance to the small- and medium-sized businesses that characterise the early stages of countries' economic development. Instead, the banks will be much more critical when it comes to financing companies.

Smaller domestic banks are much better suited to providing finance to the small businesses that dominate the manufacturing, farming and services sectors in developing countries. There is evidence to suggest that growth is faster in countries where these kinds of banks have larger market shares, in part because of improved financing for just these kind of enterprises.

Governments in low-income countries should recognise the strategic importance of small, private domestic banks. They should also carry out some fundamental reforms. On the demand side of the equation, entrepreneurs in developing economies need to be able to signal more easily that they are creditworthy. Sustained efforts to improve credit and collateral registries offer large pay-offs. Credit registries enable first-time entrepreneurs to document their personal credit histories and share them with lenders. Collateral registries enable lenders to verify that assets such as property and vehicles have not already been pledged by the borrower to secure past loans. Transparent and efficient court procedures allow lenders to seize collateral in the event of loan defaults.

Failing local banks should be acquired by stronger local banks or liquidated if no such purchaser can be found. After liquidations well-capitalised new banks should be allowed to enter the sector.

Facilitating the creation of new local banks and improving the methods for intervening to deal with troubled banks will encourage competition and provide healthier incentives. That will help banks promote the private-sector-led growth that will be crucial to recovery from the current financial crisis. [105]

[105] Economics focus: "Walk, don't run", From The Economist print edition, Jul 9th 2009

1.6.2. Making finance work better

The banking is the industry that failed. Banks are meant to allocate capital to businesses and consumers efficiently; instead, they ladled credit to anyone who wanted it. Banks are supposed to make money by skillfully managing the risk of transforming short-term debt into long-term loans; instead, they were undone by it. They are supposed to expedite the flow of credit through economies; instead, they ended up blocking it. [106]

The costs of this failure are huge. The IMF reckons that average government debt for the richer G20 countries will exceed 100% of GDP in 2014, up from 70% in 2000 and just 40% in 1980.[107]

Despite public rage over bank bail-outs, the industry has also comprehensively failed its owners. The scale of wealth destruction for shareholders has been breathtaking. The total market capitalization of the industry fell by more than half in 2008, erasing all the gains it had made since 2003 (see chart 1 above). [108]

The credit crunch has been a series of multiple crises, starting with subprime mortgages in America and progressively sweeping through asset classes and geographies.

In its latest *Global Financial Stability Report*, the IMF estimates that the total bill for financial institutions will come to $4.1 trillion.

The most seismic event of the crisis to date, the bankruptcy of Lehman Brothers last September, demonstrated the costs of letting a big financial institution collapse. Trust evaporated and credit dried up. “October was the most uncomfortable moment in my career,” recalls Gordon Nixon, the boss of Royal Bank of Canada (RBC). “There was a possibility that the entire global banking system could go under.”

The situation is fluid but analysts at Barclays Capital reckoned in March that cumulative pre-tax and pre-provision income at the top 20 American banks for this year, 2010 and 2011 will be $575 billion, just enough to cover their estimates of losses in that period of $415 billion-$560 billion.

Banks in many emerging markets will suffer as the economic climate deteriorates but they need to deleverage less. There is also less need for regulatory change. The Asian banks kept their exposure to cross-border funding flows under control, for example, unlike their peers in

[106] Special report: “Rebuilding the banks”, From The Economist print edition, May 14th 2009
[107] Ibid
[108] Ibid

eastern Europe. The scale of structural change that these institutions face is relatively limited. [109]

1.6.2.1. Fixing finance

André Sapir, of the Université Libre de Bruxelles, recently told a Financial Times conference that government policy should not be aiming to avoid a repeat of 1929: it has already failed to do that. Instead it should aim to avoid 1930-32. Taxpayers will end up carrying the load. In effect, the state will take on much of the debt that the private sector has decided to jettison. Some people will complain about that, but it makes sense to borrow to bring government spending forward. Just now, such public spending will hardly be crowding out the private sector: businesses find it impossible to borrow anyhow.[110]

The meltdown of 2008 is likely to cause a freeze during which credit refuses to grow. This could look like the aftermath of the Depression, when credit and trading in financial markets barely increased.

Senior financiers could take more of their pay in equity - and hand some back if the bank does badly. [111]This is already widely accepted practice in US corporations, but maybe not so popular among banking institutions. Nonetheless, it stimulates bankers and financiers to treat their bank of financial institution as if it were their own.

Charles Wyplosz, professor of economics at the Graduate Institute in Geneva, envisages a spectrum, with an innovative, lightly regulated but crisis-prone financial system at one extreme and a stable, heavily regulated but stodgy one at the other.

Willem Buiter, of the London School of Economics, thinks a stripped-down sort of finance could do most of what a modern economy needs. In a remarkable lecture given in 1984, near the beginning of the boom, James Tobin, a Nobel laureate (and Mr Buiter's former teacher), puts the case. His conclusion is worth quoting:

"I [suspect] we are throwing more and more of our resources, including the cream of our youth, into financial activities remote from the production of goods and services, into activities that generate high private rewards disproportionate to their social productivity. I suspect that the immense power of the computer is being harnessed to this 'paper economy', not to do the same transactions more economically but to balloon the quantity and variety of financial exchanges…I fear that, as Keynes saw even in his day, the advantages of the liquidity and negotiability of financial instruments come at the cost of facilitating nth-degree speculation which is short-sighted and inefficient.

If this is your picture of the world, then you want to constrain finance. You may well want a core of regulated banks that cannot blithely create credit, take on leverage and secrete assets off their balance sheets, as today's banks have done. Although you would allow hedge

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[109] Special report: "Rebuilding the banks", From The Economist print edition, May 14th 2009
[110] A special report on the future of finance: "Fixing finance", From The Economist print edition, Jan 22nd 2009
[111] Ibid

funds and private equity to experiment, you would seek to contain their mischief by containing their access to capital. The era of Baroque exuberance would be over."[112]

Richard Sylla, a professor of economic history at NYU Stern School of Business in Manhattan, observes how often financial sophistication has gone with military and economic power. Mr. Sylla says, that when Japan set out to industrialize in the late 1860s, almost the first thing it did was to copy the most advanced Western forms of financial management.

In a paper published at the end of 2006, Romain Ranciere, of the IMF, Aaron Tornell, of the University of California, Los Angeles, and Frank Westermann, of the University of Osnabrück, concluded that financial liberalisation raises growth by around 1% per person per year. Other studies suggest that financial innovators gain from their discoveries, and that an actively traded stockmarket tends to be a signal of present and future growth.

According to Josh Lerner, an expert in innovation at Harvard Business School, such studies are surprisingly rare compared with studies of technological innovation.

In addition, Mr. Lerner believes that financial services need to be adapted to the economy of which they form part, and the economy is always changing.

A 19th-century French business-cycle theorist Clément Juglar, argued that: "The richness of nations can be measured by the violence of the crises which they experience…"[113]

Looking back from the pit of recession, it is difficult to recall how the investment banks' pre-eminence and the hedge-funds' wealth could ever have seemed to be the natural order. A time will come when today's fear is equally hard to fathom. Greedy once again, people will wonder why they did not buy shares at that price, why they did not realize corporate bonds were a steal and why they did not foresee a bout of inflation or a weak dollar. My belief is that greed is one major element at the root of the crisis. The thirst of financiers to gain even more yields on their cash prompted them to act in ways which may not be seen ethically correct, in search of being awarded hefty bonuses.

Such shifts in perception are the result not of madness or criminality, but of individually rational responses to what Keynes saw as the inherent uncertainty in financial markets. Finance feeds on trust and mistrust, and amplifies whichever is ascendant. That is what makes financial markets dangerous.

Just now that probably seems like a reason to tie finance down. And indeed it could be better regulated, as the crisis has shown. But a thoroughgoing effort to tame finance would be futile and could come at a high cost. Frederic Mishkin, a former Fed governor, once called finance "the brain of the economy". The image conjures up power and importance, but it also evokes complexity and fragility. Finance is a remarkable creation. Do not suppress it, but use it wisely. [114] Financial instruments are not toys, even if sometimes people play with them...it all seems a game. However, they can become extremely dangerous, and expose huge banking institutions to the risk of default. Such was the case of the Barings Bank in UK, that collapsed in 1995 because of the actions of one of its traders, Nick Leeson that sought to profit from differences in the prices of Nikkei 225 futures contracts listed on the

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[112] Ibid
[113] Ibid
[114] Ibid

Osaka Securities Exchange in Japan, and the Singapore International Monetary Exchange. Leeson ended up losing £827 million ($1.3 billion) of Barings Bank money, which lead to its collapse.

2. Chapter II – The impact of the financial crisis on Romania's economy and the prospects of adopting the Euro currency

2.1. The impact of the financial crisis on the Romanian Banking sector

Eastern Europe has emerged as the IMF's main theatre of operations in the last six months, because the region has struggled to meet its large external financing needs as the global credit crunch has deepened. At the outset, Romania, Bulgaria, Hungary, Ukraine, Serbia and the Baltic states looked the most vulnerable, owing to their large current-account deficits, high external debt levels and excessive lending growth (particularly to households) in the recent past. Without access to external credit, countries with large external imbalances face a sharp correction to domestic demand in order to reduce imports, while companies with foreign loans due face the threat of bankruptcy. These financial pressures are occurring against a backdrop of other economic fallout from the global crisis. The bulk of east European exports are to the euro zone, most of whose members are now in recession. As a consequence, east European currencies have faced hefty depreciating pressure.[115]

As a result of the economic crisis, Romanian banks have seen their revenues diminished substantially and financing to the firms and public came to an almost complete halt at the beginning of 2009. Compared to the credit excesses of 2008, the year 2009 looked much grimmer. In 2008, the NBR warned against banks offering financing to citizens solely on the basis of presenting their ID card. This has triggered a boost in consumption. 2009 on the other hand was, up to now the year of prudential approach called by the NBR. Even though many government officials stated at the beginning of the year that the crisis would not affect Romania, this has not been so. Many companies owing money to the banks found themselves a position in which they were unable to pay their creditors. This was mainly due to the fact that their suppliers/clients abroad stopped sending payments. Banks on the other hand are forced to provision those financing facilities that are unpaid for more than 90 days. However, the NBR's prudent policy has slowed the credit flow almost up to a total halt. Given the fact that the previous years' boom in housing prices was mainly caused by the availability of credit from the banks, it was inevitable that the real estate market would register a major slowdown such as in other developed and developing countries. The Government has tried to restart the lending by launching the program "Prima casa" (first house) that is backed by the government and is targeted at young people buying their first house. The idea was to stimulate the construction market by determining young couples to buy newly built houses. Instead, many still preferred apartment houses in buildings built before 1989. In my view this is a just one step in restarting the economy. The government believes that banks are those that are reluctant to restart financing to firms and private individuals, however this is not the case. After the devaluation of the Leu, many banks stopped lending in Euro except to those companies that have business activities abroad, in

[115] Economist Intelligence Unit Briefing: "Credit for Poland", From The Economist Intelligence Unit ViewsWire, Apr 16th 2009

order to avoid exposing firms and private individuals alike to currency fluctuation risk. It is true that it is generally better to borrow in the Leu currency, however the interest rates for the local currency are much higher, even two to three times higher. Under these conditions, not many are rushing to the banks.

2.2. NBR and the Government determined the banks to keep funds in Romania

Up to now, western banks have supported their eastern European subsidiaries in overcoming the difficult situation in their own markets. In Romania, the government together with the NBR have called the representatives of foreign banks that have subsidiaries in Romania, at a meeting, in order to sign an agreement in which they engage not to drain their subsidiaries of the liquidity that they have. This measure was meant to maintain a liquid market so that financing to firms could keep flowing, thus allowing the economy to operate normally. This method has been effective thus far in keeping liquidity in the country, but this liquidity has not necessarily been readily available to the economy. However, this is not the fault of the government nor the NBR but rather the result of deteriorating of the financial situation in Romania, which, in turn caused the real estate market to drop and the firms to default on payments to creditors and suppliers.

From The Economist point of view, a Western bank could even abandon a local subsidiary, although Mark Young of Fitch, a credit-rating agency, thinks that is pretty unlikely as it would create wider fears among depositors and counterparties about foreign parents' resolve to stand by their CEE operations.

Beyond the Baltics, funding from foreign banks to subsidiaries also looks solid. Romania, Serbia and Hungary have extracted commitments from lenders to maintain their exposure. This, along with help from the IMF, has been "an incredibly stabilising factor" for the wider region, says Manfred Wimmer, chief financial officer of Erste Group, an Austrian bank with big eastern European operations.

Experts have long warned against generalising about the region. So far this advice has proven right, with big discrepancies in impairment levels between countries. In the first quarter UniCredit, an Italian bank, recognised bad debts in Ukraine and Kazakhstan equivalent to an annualised rate of about 5% of loans. Yet the number for Poland was just 0.5%, and for its CEE unit overall 1.7%. The same variety typifies the other three Western banks that are most active in the region, KBC of Belgium, and Erste and RZB of Austria.

Bad debts everywhere will soar, however. There will be "serious pressure" on provisioning, says Federico Ghizzoni, who is responsible for UniCredit's CEE operations. Is there enough capital to absorb the losses? Taking UniCredit, KBC, Erste and RZB together, and assuming a 40% loss rate in high-risk countries like the Baltics and Ukraine and a 10% loss rate elsewhere in the CEE region, the hit would eat up about a third of their combined tier-one capital—bad, but not terminal. Again, governments are standing by, having already injected funds into KBC and the Austrian banks. UniCredit is in negotiations to secure a combined €4 billion capital injection from Italy and Austria.

The response to the crisis so far, with the IMF providing credit to the neediest eastern European governments and western governments offering support to their banks in the region, seems to have worked. That still leaves banks to work through bad debts and build up their local funding levels. Mr Ghizzoni says there is now "fierce competition for deposits". The spivvy business model of borrowing euros and Swiss francs in the wholesale markets and then ramming them down CEE customers' throats is dead. But the commitment of most western European banks to the region is, if a little grudging, still alive.[116]

2.2.1. Measures adopted by the National Bank of Romania

2.2.1.1. Reducing the minimum reserves for the Leu and Euro

"On 30 June, the NBR took firm steps to ease its monetary policy stance: It cut the key rate by 50bp to 9%, and it reduced banks' minimum reserve requirements from 18% to 15% for lei and from 40% to 35% for foreign currencies (effective from 24 July). The rapid deceleration of economic activity in the last two quarters, poor expectations regarding a recovery in the next period, and the falling inflation rate were the main reasons behind the NBR's decisions. Statements following the recent monetary policy meetings showed that central bank have become more concerned about the slump in the economic activity (and most likely, the large fall in real GDP surprised also the central bank). In fact, in last period there were more comments form central bank's officials suggesting that risks for a plunge in real GDP much higher than 4 percent (the assumption of the IMF stand-by program) have increased.

The central bank is also concerned about "the significant slowdown" of the credit to the private sector. Outstanding loans for private sector both in RON and in foreign currencies are falling since the end of October as supply and demand of loans decreased. Money market interest rates have decreased rapidly over the last months, falling from 14% in March to 10% in June. However, decline in lending and deposit rates was much lower (especially in case of lending interest rates). Clearly, last monetary policy decisions were aimed at speeding up the decline in deposit and lending interest rates in the economy in order to help stimulate an economic recovery. In the statement following the monetary policy decision the NBR said: "The NBR Board considers that these decisions will contribute to ensuring an adequate level of liquidity and a gradual return of banks' deposit and lending rates to the appropriate functional position in relation to the monetary policy rate." Much

[116] Banks' exposure to eastern Europe: "Stand by me", From the Economist print edition, Jun 11th 2009

more, by reducing minimum reserve requirements, the NBR will boost additional liquidity in the banking system, around RON 3 bn and by EUR 1.4 bn. We recall that banking system liquidity increased also by EUR 940 mn in May following the removing of minimum reserve requirements for banks liabilities in foreign currencies with maturity beyond 2 years. Therefore the banks would have more liquidity and more resources to extend lending in the economy. However, we don't expect these additional resources to be completely channeled to the private sector. A portion of this money will most likely end up financing the public budget deficit (with banks buying government securities). In last six months, the banks have become the main funding source of the public budget deficit, holding around 83% of outstanding government securities in their portfolio."[117]

While these measures were meant to stimulate saving on the part of population and financing from the banks, lending has not restarted to proper levels. As a matter of fact, in the first half of the year, the population that had deposits searched for the best offers on the market for placing their funds. As a result, they have moved around their funds from bank to bank until interest rates on the deposits dropped. As to lending, the problem is not that banks are not willing to lend, but there is very low demand from the market. Financing of the private individuals has almost frozen as compared to the excess that was achieved in 2008. Businesses have in great part defaulted on repaying the credit facilities obtained from the banks, recurring to methods such as calling for insolvency procedures to avoid paying back funds to banks and to Romania's State Budget. Even if some firms or private individuals were to ask for financing, their real estate assets cannot be accepted at the value they had in 2008, but at a much lesser value. Those that have ongoing financing that they are repaying, are called by the banks to supplement the guarantees backing their financing, because the value of their mortgaged real estate has dropped significantly since last year, below the value of the credit facilities. Most are doing it, some are not. One thing is certain though: given the current situation of the real estate market, Romanian banks try as much as possible avoiding foreclosures until the real estate market recovers.

2.2.1.2. The chairman of the NBR – Mugur Isărescu

At a seminar on economic topics held at the National Bank of Romania in July 2009, the Governor Mugur Isărescu has dealt with various subjects regarding the context of the crisis, the possible evolutions and has presented a few of his opinions regarding the current situation.[118]

He believes that the economy must recuperate after the adjustment, because "a correction is achieved either through market automatism or through policies. One such process is not easily controllable". In his view, any adjustment has costs regarding economic growth. On the other hand, a major correction of foreign deficit could have inflationary costs if it is achieved through the exchange rate.

The Governor warned the commercial banks that they should avoid repeating the excess that was done with excessive financing in 2008 with the interest rates of the deposits. He believes that promotional interest rates for the deposits are too high, reaching 12-13%.

[117] Raiffeisen Bank S.A.: „Economic Overview – Romania", August 2009
[118] Sfaturile lui Mugur Isărescu pentru perioada de criză: http://www.capital.ro/articol/sfaturile-lui-mugur-isarescu-pentru-perioada-de-criza-121710.html

The NBR Governor believes that the "Agreement with the IMF and the European Union is in itself an anti-crisis program" and considers that the word "crisis" is abused. He has shown that the problem right now is the recovery of economic growth.

"Who believes that they can engage the banks to give financing if they talk of recession, crash, unemployment, etc.? This attitude freezes from the start the appetite to finance". The Governor explained that right now clients are not stimulated to get credits because of prohibitive interest rates, both for deposits and credits alike.

Mr. Isărescu believes that the absorption of EU (structural) funds should be restarted gradually. He explained that the Central Bank believes in a prudent loosening requirements in minimum reserves constituted by the banks, that have thus turned from liabilities into assets :"The EU funds are very large also compared to the potential of the Romanian economy, and to what we have demonstrated that we can absorb until now. There must be a gradual restart in absorption, because the Romanian Economy is not prepared to absorb them more quickly".

We are dealing with a "V-shaped" recession

The Governor states: *"Usually, this type of recession, because of the outflows of capital or due to a lesser generosity of foreign capital towards Romania, is "V" shaped. If I look at the industrial production, I see the lower part of the "V" somewhere in February. But maybe I am not seeing well. I am not making a case of this".* The Governor moves on to state that this type of economic evolution is defining for those countries without a long history of market economy and the closest example to us is Turkey because it has spectacular drops followed by spectacular growth.

2.2.1.3. Maintaining exchange rate stability

According to the Governor of the National Bank of Romania, Mugur Isărescu, the current account deficit and short term foreign debt have registered an obvious improvement, which has led to the stability of the exchange rate. In a press conference organized to present the quarterly report on inflation, the Governor said that "there is an evident improvement in the economic fundaments that have determined the reduction in Romania's rating and the pressures on the exchange rate. He didn't miss the occasion to state that many have been waiting for six months to see the exchange rate go up to 4.7 lei/euro. Mr. Isărescu has shown that there is coverage of the current account deficit of 100% from foreign investment, which leads to the creation of a surplus on the money market.[119]

2.2.2. Measures adopted by the Romanian Government

2.2.2.1.Romania's Stand-by agreement with the IMF, European Commission, World Bank and EBRD

[119] Mugur Isărescu: "Parcă n-aş încuraja nici o apreciere a leului": http://www.capital.ro/articol/isarescu-parca-n-as-incuraja-nici-o-apreciere-a-leului-123277.html

On 25 March, Romania agreed with international institutions (the IMF, European Commission, World Bank, and EBRD) on a financing package amounting to EUR 19.95 bn over the next two years. The bulk of money should come from the IMF - around EUR 13 bn, or 65% of the total, while the European Commission would provide EUR 5 bn. Not in the last, the World Bank, EBRD, and EIB are expected to lend Romania EUR 2 bn.[120]

The main aim of the external financing package is to smooth the macroeconomic adjustment process in Romania after the drop in external capital inflows. Funding ensured by the external financing package and the policy measures agreed under the stand-by program with the IMF should stabilize and improve the expectations and confidence of foreign investors in Romanian economy.

Structure of the external financing package (EUR bn)

	2009	2010	2011	Total
IMF	8.5	3.5	1.0	**13.0**
European Commission	2.5	2.35	0.15	**5.0**
World Bank	0.5	0.5	0.0	**1.0**
EIB/EBRD	0.3	0.7	0.0	**1.0**
Total	**11.8**	**7.0**	**1.1**	**20.0**

Source: IMF – Romania: Request for Stand-by Arrangement

Expected disbursements under the IMF stand-by program

Period		SDR mn	EUR mn
2009	May	4370	4925
	Sep	1718	1936
	Dec	1409	1588
2010	Mar	766	863
	Jun	768	865
	Sep	769	867
	Dec	769	867
2011	Mar	874	985
Total		**11443**	**12895**

Note: Converted from SDR in EUR at the exchange rate of 1 SDR = 1.12691 EUR as of 6 May 2009. Starting September 2009, disbursements will depend on the completion of quarterly reviews.

Source: International Monetary Fund

The IMF Board approved the stand-by program and the loan for Romania on 5 May. Romania already received around EUR 4.9 bn on 6 May. The next disbursements, scheduled on quarterly basis, are constrained by the fulfillment of quantitative performance criteria. The money from the IMF goes to the central bank's reserves to consolidate the international reserves. The NBR committed to start releasing the minimum reserves in foreign currency of the commercial banks in order to stimulate lending activities. In fact, the NBR already cut to 0% from 40% the reserve requirements for banks' liabilities with maturities higher than 2 years (and without early repayment clauses) as of 24 May. On 30 June, the NBR also decided to lower FCY reserve requirements from 40% to 35% starting 24 July.[121]

Money from the European Union would come in five installments. First installment amounting to EUR 1.5 bn is expected to be disbursed by the end of July. Also, the World Bank is expected to approve in July the first tranche of the loan amounting to EUR 300 mn. Money received form the European Commission and the World Bank will go to the Ministry of Finance, being aimed at financing the budget expenses (and so the budget deficit).

Money received from the EBRD and EIB will go in the private sector. There would be loans for Romanian companies and banks (in some case guaranteed by the government).

The stand-by program agreed with the IMF will be monitored through quantitative performance criteria and indicative targets, structural benchmarks and consultation clauses, during quarterly reviews. Compared to Poland which has a Flexible Credit Line with the IMF with no conditions whatsoever, Romania must meet the IMF's criteria in order to be allowed to draw more funds. I will not go into the details of these criteria since they do not serve the purpose of this paper.

[120] Raiffeisen Bank S.A.: „Economic Overview – Romania", August 2009
[121] Ibid

On an exceptional basis, the IMF has allowed the Romanian government to use some of the funds for financing its budget. This means that instead of going to finance investments, the money will be used to pay salaries and pensions. This is a tricky approach in my view because once the money is used up, more will be needed and no benefit will come from their use, except preventing social unrest caused by the government's defaulting on the payment of salaries, pensions and social security for the unemployed, at a moment preceding the Presidential election in November 2009.

2.2.2.2. Romania's future economic forecasts

Before discussing Romania's perspectives of entering the euro-zone, there is some interesting updated information to go over, concerning the reduction in trade deficit registered by Romania.

According to The Economist, *"Romania's trade deficit has shrunk by three-quarters this year, easing concerns about coverage of the current-account deficit."*[122]

The weakening of the exchange rate in the last 6-9 months has caused and increase in food and beverages exports. However, *"in the majority of Romanian sectors there are few signs of an output recovery prompted by a more competitive leu.*

Romania started 2009 as one of those east European states with a sizeable external financing requirement in relative and absolute terms, in large part because of its trade deficit. Data for the first half of the year show a dramatic turnaround. The current-account deficit in January-June was €2.4bn, compared with €8.9bn in the year-earlier period-73.3% smaller year on year. Foreign direct investment (FDI) inflows into Romania fell 43% year on year in the first half of 2009, amounting to just over €2.5bn. Although this is a large drop, FDI inflows more than covered the current-account deficit and thus eased concerns about a balance-of-payments crisis.[123]

"The current-account deficit narrowed despite a reduction in the transfers surplus and the emergence of a small deficit on services. The income deficit narrowed but the major change was in the trade deficit. On a balance of payments basis, the trade deficit fell to €2.9bn (US$4.1bn) in January-June, compared with a shortfall of €8.6bn in the corresponding period of 2008."[124]

The Economist wonders how this dramatic change was achieved. Looking into the figures from the INSEE, "nearly half of the decline in imports was attributable to lower imports of machinery and transport equipment, which fell by €3.9bn. The next two largest falls, registered by manufactured products (€1.8bn) and mineral fuels (€1.5bn) are not as large even when taken together."[125]

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[122] Economist Intelligence Unit Briefing: "Trade surprises", From The Economist Intelligence Unit ViewsWire, Aug 27th 2009
[123] Ibid
[124] Ibid
[125] Ibid

In relative terms, the largest collapse in import spending was seen in the categories of mineral fuels (down by 55%) and raw materials (down by nearly 50%). Romania as we know, covers a sizeable portion of its oil and gas requirements through domestic production therefore, in the context of weaker domestic consumption, it's normal that fuel imports should fall sharply. Imports of manufactured products fell by nearly 40% and imports of machinery and transport equipment fell by around 44%. The Economist is particularly keen on understanding if the drop in machinery refers to the failure to replace aging machinery or to the import of luxury cars from Western Europe. In the first case, the issue could become a problem in the future. In the second case, The Economist is not concerned that a slowdown in the import of luxury cars from Western Europe will affect Romania's ability to recover.

The article mentions that here is a sign that the decline in exports is close to bottoming out, or has done so already, while imports show no tangible sign of improvement: they fell by 35% in June, compared with contractions of 35.3% and 34.6% in May and April.

Also, it seems that the more competitive Leu has benefited Romania's food, beverage and tobacco producers, because demand for those products is relatively inelastic. However, it is possible that the weaker Leu will boost other branches of Romanian manufacturing as the country's main export markets exit recession.

2.2.3. Adopting the Euro

2.2.3.1. The requirements for adopting the euro

As the European Union expands new member states by the process known as enlargement, analogically the euro-area is gaining new members as member states meet the criteria for entry.[126]

All the EU Member States must join the euro area once they meet the parameters to do so, with the exception of Denmark and the United Kindgom which have negotiated an 'opt-out' clause that allows them to remain outside the euro area.

The economic criteria that countries must meet prior to the adoption of the Euro are wrapped up as the economic 'convergence criteria' which are designed to ensure that a Member State's economy is sufficiently prepared for adoption of the single currency and can integrate smoothly into the monetary regime of the euro area. In the same way, legal convergence requires that national legislation, in particular the national central bank and monetary issues, is compatible with the Treaty.[127]

Replacing a national currency with the euro is a major operation that demands many practical preparations, for instance ensuring that the national currency is withdrawn quickly, that prices of goods are properly converted and displayed, and that people are kept well informed. All these preparations rely on the particular 'changeover scenario' that a euro-area candidate country adopts. Significant experience was gained when the euro was first launched, which benefits euro-area candidate countries today. The European Commission, in particular, offers much help and advice to euro-area candidate countries.[128]

[126] Adopting the Euro: *http://ec.europa.eu/economy_finance/the_euro/the_euro6480_en.htm*
[127] Ibid
[128] Adopting the Euro: *http://ec.europa.eu/economy_finance/the_euro/the_euro6480_en.htm*

2.2.3.2. The euro - What is ERM II?

The ERM II stands for Exchange Rate Mechanism and was set up on 1 January 1999, as a successor to ERM with double function: to guarantee that exchange rate fluctuations between the euro and other EU currencies do not create economic instability within the single market, and to give support to non euro-area countries in preparing themselves for participation in the euro area.

"Within the euro area, there is only one currency – the euro – but there are EU countries outside the euro area with their own currencies, and avoiding excessive fluctuations in their exchange rates with the euro or misalignments helps the smooth operation of the single market. It is ERM II that provides the framework to manage the exchange rates between EU currencies, and ensures stability."[129]

In order to qualify to adopt the euro, a country must participate in the ERM II mechanism for at least two years without major tensions, as this is one of the convergence criteria for entering the euro area.

How does ERM II work?

In ERM II, the exchange rate of a non-euro area Member State is fixed against the euro and is only allowed to fluctuate within set limits. ERM II entry is based on an agreement between the ministers and central bank governors of the non-euro area Member State and the euro-area Member States, and the European Central Bank (ECB). It covers the following:

- A central exchange rate between the euro and the country's currency is agreed. The currency is then allowed to fluctuate by up to 15% above or below this central rate.
- When necessary, the currency is supported by intervention (buying or selling) to keep the exchange rate against the euro within the ±15% fluctuation band. Interventions are coordinated by the ECB and the central bank of the non-euro area Member State.
- Non-euro area Member States within ERM II can decide to maintain a narrower fluctuation band, but this decision has no impact on the official ±15% fluctuation margin, unless there is agreement on this by ERM II stakeholders.
- The General Council of the ECB monitors the operation of ERM II and ensures co-ordination of monetary- and exchange-rate policies. The General Council also administers the intervention mechanisms together with the Member State's central bank.

A measure of sustainable economic convergence

When a Member State enters the euro area, its central bank becomes part of the Eurosystem made up of the national central banks of the euro area and the ECB, which conducts monetary policy in the euro area independently from national governments.

The consequence of this is that euro-area Member States can no longer have recourse to currency appreciation or depreciation to manage their economies and respond to economic shocks. For example, they can no longer devalue their currency to slow imports and encourage exports. Instead, they must use budgetary and structural policies to manage their economies prudently.

[129] The Euro: What is ERM II?: http://ec.europa.eu/economy_finance/the_euro/joining_euro9407_en.htm

ERM II mimics these conditions thereby helping non-euro area Member States to prepare for them. Successful participation in ERM II for at least two years is considered as confirmation of the sustainability of economic convergence and that the Member State can play a full role in the euro-area economy. It also provides an indication of the appropriate conversion rate that should be applied when the Member State qualifies and its currency is irrevocably fixed.

Here I would like to mention that in certain cases, developing countries in Europe have mistakenly believed that given the fact that the procedures for adopting the euro are in force, their local currencies can only appreciate compared to the euro. This view was wrong because their currencies depreciated and those that had access to financing in foreign currencies are now exposed to fluctuations in exchange rates. This is also valid for companies, not only for individuals. Even in Romania, this has occurred triggering the NBR to take measures to determine the local banks to lend only in exceptional cases euro (such as in the case of firms that deal with imports/exports). In all other cases the financing must be provided in the Romanian Leu.

As an example, here is a list of EU currencies included in the Exchange Rate Mechanism (ERM II):

Denmark*: the Danish kroner joined ERM II on 1 January 1999, and observes a central rate of 7.46038 to the euro with a narrow fluctuation band of ±2.25%.*

Greece*: the Greek drachma joined ERM II on 1 January 1999, and observed a central rate of 353.109 to the euro with a standard fluctuation band of ±15%. On 17 January 2000, the central rate was revalued to 340.750. The Greek drachma left ERM II when Greece adopted the euro on 1 January 2001.*

Estonia*: the Estonian kroon joined ERM II on 28 June 2004, and observes a central rate of 15.6466 to the euro with a standard fluctuation band of ±15%.*

Lithuania*: the Lithuanian litas joined ERM II on 28 June 2004, and observes a central rate of 3.45280 to the euro with a standard fluctuation band of ±15%.*
Slovenia*: the Slovenian tolar joined ERM II on 28 June 2004, and observed a central rate of 239.640 to the euro with a fluctuation band of ±15%. The tolar left ERM II when Slovenia adopted the euro on 1 January 2007.*

Cyprus*: the Cyprus pound joined ERM II on 2 May 2005, and observed a central rate of 0.585274 to the euro with a fluctuation band of ±15%. The Cyprus pound left ERM II when the country adopted the euro on 1 January 2008.*

Latvia*: the Latvian lats joined ERM II on 2 May 2005, and observes a central rate of 0.702804 to the euro with a fluctuation band of ±15%, but Latvia unilaterally maintains a 1% fluctuation band around the central rate.*

Malta*: the Maltese lira joined ERM II on 2 May 2005, and observed a central rate of 0.429300 to the euro with a fluctuation band of ±15%, but Malta unilaterally maintained the exchange rate of the lira at the central rate without fluctuation. The Maltese lira left ERM II when the country adopted the euro on 1 January 2008.*

Slovakia: *the Slovak koruna joined ERM II on 28 November 2005, and observed a central rate of 38.4550 to the euro until 19 March 2007 when it was revalued to 35.4424. On 29*

May 2008, it was again revalued to 30.1260, while maintaining the standard fluctuation band of ±15%. The Slovak koruna left ERM II when the country adopted the euro on 1 January 2009.[130]

2.2.3.3. Case study: The successful introduction of the Euro in Slovenia

In this Communication, the European Commission analyses the main aspects of introducing the euro in Slovenia from 1 January 2007. It looks at the introduction of euro banknotes and coins, the switchover of administrative and financial systems in both the public and private sectors, and the way in which prices actually changed (as well as the public's perception of this) following the changeover. The Commission outlines the main lessons which the successful introduction of the euro in Slovenia can teach countries adopting the euro in future.[131]

Following the Council Decision of 11 July 2006, Slovenia introduced the single currency on 1 January 2007. In this Communication, the Commission outlines the main lessons to be learnt by countries adopting the euro in future.

Ensuring a quick changeover: the "big bang" scenario

Slovenia's "Masterplan" for the euro changeover is based on the so-called "big-bang" scenario, whereby euro banknotes and coins are introduced on the same day as the euro is adopted (1 January 2007 in the case of Slovenia). The countries which adopted the euro earlier (eleven countries in 1999, and Greece in 2001) did not introduce banknotes and coins until 1 January 2002. Between 1999 and 2001, the euro could only be used as bank money in these countries (for cheques or bank transfers, for example).

The European Commission favours the "big-bang" approach for new countries joining the euro zone. Therefore, this method might be used for Romania when adopting the Euro, in 2014 or later. This approach appears to be the most appealing one because of its simplicity in terms of communication and information.

Both the Slovenian tolar and the euro were in circulation at the same time in the period from 1 January to 14 January 2007. After this period of dual circulation, the euro became the sole legal tender. Those still in possession of tolar banknotes and coins can exchange them for euros at branches of the national central bank.

The backflow of tolar cash started in November and December 2006, and was remarkably fast, especially for tolar banknotes. The return of legacy currency had caused severe bottlenecks during the first-wave transition in 2002.

Supplying banks and retailers with euros

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[130] Adopting the Euro: *http://ec.europa.eu/economy_finance/the_euro/the_euro6480_en.htm*
[131] Slovenian changeover to the euro (by Deloitte): http://ec.europa.eu/economy_finance/publications/publication12540_en.pdf

“Before the euro changeover date (" Day"), banks and other financial institutions have to be supplied with sufficient quantities of euro banknotes and coins by the central bank, a process called frontloading. In turn, the banks try to ensure that businesses involved in cash-related operations, and retailers in particular, are supplied with euro cash before Day to allow them to give change exclusively in euro, thus avoiding the recycling of legacy currency. As they bring the new euro cash into circulation, banks and retailers at the same time need to cope with the rapid backflow of legacy cash.”[132]

The Bank of Slovenia received a total of 94.5 million banknotes with a face value of 2 175 million from the Eurosystem's logistical stocks. A total of 296.3 million euro coins with a face value of 104 million were supplied by the Mint of Finland. Slovenia does not have its own national mint and selected the Finnish Mint as its coin supplier following a public tender procedure.

The conversion of financial administrative systems

The some 2.3 million bank accounts held by private persons and by businesses, associations and other legal entities were successfully converted into euro.[133] This might prove to be quite easy to do in Romania, given the fact that many private persons and business already have obtained financing in euro. However, there could be a problem with setting the fixed exchange rate between the euro and the Romanian Leu, because if the exchange rate is too high, it may cause problems to those entities. We should keep in mind that this is very important for calculating salaries, taxes, pensions and so on. Given the fact that right now Romanian citizens receive their salaries in the Leu currency, they could see their purchasing power diminishing.

With regard to the conversion of administrative and financial systems to the euro, the Commission confirms that the "big-bang" scenario is much more demanding than the " Madrid scenario " which was applied during the first changeover wave. At the time, public administrations and private businesses benefited from a three-year transitional period extending from 1999 to 2001 (one year in the case of Greece) to convert these systems to the euro. Slovenian administrative bodies and businesses were expected to operate exclusively in tolar up to 31 December 2006 and switch all their systems to the euro as of 1 January 2007. This challenge was met because the administrations and business were able to prepare themselves adequately and in good time. No particular problems were experienced or reported.

Monitoring prices [134]

The dual display of prices started in March 2006 and will continue until mid-2007. The Slovenian Consumers' Association has been monitoring prices ("PriceWatch") and has asked consumers to report price rises so that these can be published and possible abuses limited.

In January 2007, the Statistics Office of the Republic of Slovenia (SORS) released its first analysis of the impact of the changeover on prices in December 2006. The impact of unusual

[132] The successful introduction of the euro in Slovenia: http://europa.eu/legislation_summaries/economic_and_monetary_affairs/introducing_euro_practical_aspects/l25092_en.htm
[133] Ibid
[134] Ibid

price increases in restaurants, bars and coffee shops was estimated to be no more than 0.12%. The impact on the other expenditure groups was also estimated at 0.12 percentage points. For January 2007, SORS highlighted some other unusual price increases for the same purchases, as well as for recreational and sports services.

Based on the information provided by SORS, Eurostat considers that the likely impact of the changeover on consumer prices during and after the changeover period could be in the order of 0.3%. The fall in the all-items annual HICP inflation rate in January 2007 to 2.8%, and the further fall in February 2007 shows that the changeover effects, although noticeable, do not seem to be of such a magnitude as to drive consumer price inflation as measured by the all-items HICP. These observations are very similar to those made during the previous changeover to the euro. Eurostat will update its conclusions concerning the impact of the changeover if necessary, as further information becomes available.

Informing citizens is crucial: perceived inflation and actual price changes

In Slovenia, perceived inflation rose in January and February 2007 despite the fact that prices overall actually decreased during these two months. These observations are very much in line with those made during the first changeover to the euro. In Slovenia's case, however, there was a slight decrease in perceived prices in March. This decrease may be due to intensified communications efforts by the Slovenian authorities.

If perceived inflation continues to decrease, the situation in Slovenia may be different to the one observed in the euro zone, where perceived inflation continued to climb steeply and consistently for almost a full year after euro banknotes and coins were introduced in 2002. Five years on, this disparity has still not been eliminated entirely.

The Slovenian changeover experience shows once again that perception, expectation and reality with respect to price changes do not necessary go together. It is clear that a change of currency affects people's value scales and triggers a gradual mental adjustment process. Public perception of prices remains a key concern for future changeovers.

3. Conclusion

After presenting the effects of the international financial crisis in the US, Europe, Asia and the impact on Romania’s economy, it’s time to draw the line and present the results of the analysis of these events and possible future solutions to these problems.

As we were able to see, the current financial crisis was caused by a multitude of factors: the flow of large amounts of money from Asia to the US in search of high yields, the creativity of financiers that have designed new risky financial instruments, the availability of cheap credit to everyone who asked for it (instead of giving it to companies and individuals to invest), the boom of “shadow banking system” which has grown tremendously, reaching the size of the conventional banking system, thus becoming a systemic risk (from which the famous quote “too big to fail” or “too big to let fail”). In the US, the financial crisis was stronger that in other parts of the world, as its banking institutions started to collapse under a chain of events. What basically happened is that many of the mortgage loans given to consumers were of poor quality, those people barely qualifying for such loans, let alone repay them. One would ask himself why did these people expose themselves to such risks

(the risk of defaulting on payments, thus risking foreclosures on their properties). The answer, however simple, is: "because they could". We might view this as a failure of banking institutions to fulfill their main role: to finance businesses and individuals that bring value to the economy, not just plain consumption.

But why does the US government allow people with poor credit rating to get financing? The answer may be a social one: because these people work harder to repay their mortgages and meet their car payments. The government even offers a tax break for buying a new house. This way the economy keeps moving. Unfortunately, cheap credit has caused the housing prices to go sky high. Now those prices have come tumbling down and many owners decided to stop paying for an asset a value that is higher than what it's worth.

However, by doing so, they consume more than they earn, and borrow even more until they become prisoners of the financial institutions and find it impossible to get out of this trap. Then they work even harder, out of fear of loosing everything. It takes just one burden too much on their poor financial balance to make them default. And once many people stop paying back their loans, banks and other financial institutions declare looses and are forced to raise interest rates. These in turn trigger a second wave of defaulting payments because other people cannot bear the weight of the new interest rates. The crash of the financial market was not caused just by this simple phenomenon. It was also caused by the factors mentioned before. Also, the news that a crisis is underway determines consumers to take out their fund out of the banks, thus living them with no liquidity.

In Romania, the NBR has tried to stop rumors of financial crises of all sorts because this would aggravate the situation. The government acted swiftly to guarantee bank deposits up to 50.000 Euro per account, in order to stimulate the consumers to keep their money in the banks. Thus far this method has worked.

In Europe, the crisis manifested rather quickly and some European Banking Institutions incurred large losses from their large exposures in US's shadow financial institutions that operated outside the regulations of the conventional banking system. Even if the blow was rather hard, the Euro currency kept strong, beyond expectations. However, this was with a price: the developed countries of Western Europe took the burden of keeping the European economy afloat. As a matter of fact, as stated earlier, the developed economies were hit harder by the crisis than the less developed ones. This is in part due to the fact that emerging economies have less developed financial markets.

In Romania, the NBR has taken rough measures to prevent the crash of the banking sector in the first quarter of the year, countering the speculative attack of the subsidiaries of a handful of foreign banks on the Romanian currency, the Leu. The NBR was so far successful at maintaining a constant exchange rate of the Leu against the Euro, which is now around 4.22 Lei/ 1 Euro. However, the financial specialists have split views: some see a depreciation of the local currency while others see a slight increase of the value of the Leu compared to the Euro.

As mentioned before, Romania has signed a financial package, with the IMF, World Bank and European Commission. Compared to Poland, Romania has to meet certain criteria for keeping its right to draw installments over a 2 year period. The Romanian Government has indebted itself by issuing bonds to be sold to local banks.

The Romanian Government has adopted strategies to stimulate the construction market, housing market and credit market through the program “Prima casa”. This program was in the view of the government successful so far, but has failed to restart the construction market because most houses sold are not new but have been built before 1989.

The Presidential elections in the following November are also responsible for political instability between the ruling parties, the PDL and the PSD, that rarely agree on important issues. This pressure is due to increase as the election date approaches.

According to the ING Romania Bank, *„Looking forward, 2009 is expected to be a recession year (growth estimated at about -3.5%). As the global environment is difficult and domestic demand is expected to remain low, we forecast a gradual recovery of the economy. Economic growth is likely to reach its potential only after 2011, which means a U-shaped adjustment pattern (0% in 2010 and 2.6% in 2011). This is also because growth recovery in Romania depends heavily on growth resumption in the US and Euro zone and improved market sentiment. Appropriate local economic policies are likely to take away part of the pain, but we do not see them as enough to bring strong growth as foreign investment is needed, not just in Romania, but throughout the CEE region.*
The euro adoption story not only remains on the cards, but now there are talks of accelerating the process. We view such intentions as favorable for medium- to long-term growth given that they require reforms in different areas (including fiscal), but do not believe 2014 is a viable target.”[135] Based on the facts presented before, I believe that Romania can recover from the crisis only through sound economic reform, learning to better absorb EU funds and invest them in infrastructure, and reduce spending in the public sector.

I hope that reading this paper was as interesting to you as it was for me in writing it. It was not an easy task to decide what information to mention and which not. The topics analyzed in this paper are very complex and there are many economists are trying to make sense of all the available information. It is however hard to analyze all possible aspects of the current financial crisis and the measures needed to prevent it from worsening and helping global economies recover. Keeping this in mind, I have tried to present the readers with a comprehensive picture of the situation (as much as possible) and to show the most important points of view. However, it has not been possible to present every single element of the Bibliography. In this research project I adopted a macro-economic approach to things, but in future researches I will focus more on the micro aspects of banks and markets and strategies. I expect this project to be the beginning of future research on my part and of unique findings.

[135] Chidesciuc, Nicolaie Alexandru - Muscalu, Vlad: ”Hope for Sunshine After Rain?” by ING BANK N.V. AMSTERDAM - BUCHAREST BRANCH, 2009

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